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Macroeconomic Policy Support for Socio-Economic Development in the Lao PDR

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Committee for Planning and Cooperation
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FOREWORD

This cooperation program entitled "Macroeconomic Policy Support for Socio-Economic Development of the Lao PDR" was conducted within the framework of the technical cooperation program of the Government of Japan, in response to the request from the Government of the Lao People's Democratic Republic.

This cooperation was carried out as joint research by professionals specializing in economic policy from both Japan and the Lao People's Democratic Republic. The Committee Members headed by Yonosuke HARA, Tokyo University for the Japanese side, and by H.E. Bouathong VONGLOKHAM initially and followed by H.E. Dr. Thongloun SISOULITH, President of the Committee for Planning and Cooperation for the Lao side were set up in each country.

The Committee members held a series of discussions, conducted field surveys and jointly prepared this report on a mutual understanding.

I hope that the useful recommendations presented in this report will contribute to the formulation of policies, and it would be my great pleasure if this report would be the backbone of socio-economic development of the Lao People's Democratic Republic.

I wish to express my sincere appreciation to Professor HARA, H.E. Bouathong VONGLOKHAM, H.E. Dr. Thongloun SISOULITH and each Committee member for their close cooperation extended to the study, and to the officials concerned for their valuable opinions.

July 2002

川上隆朗

Takao KAWAKAMI
President
Japan International Cooperation Agency

PREFACE

It is a great honor for both of us to present our policy recommendations, based on the two years of Lao-Japan joint study on macroeconomic policy and development, to the government and the people of Lao PDR.

The Lao-Japanese study-team fully understood the high growth rate target set by the Lao government in its long-tem socio-economic development plan, as it is the desire of the Lao government to catch up with the development process of neighboring countries as soon as possible.

However, the study has emphasized that in the contemporary days of globalization, careful and efficient utilization of unique characteristics, in other words comparative advantage, of the Lao economy and resources is more meaningful and efficient in the long run, than the mere catching-up of per capita income. We have also emphasized that the increase of income is not the final goal, but it is the means of development that is more important. The final goal is to improve the well being of the Lao multi-ethnic people under the conditions of 'peace, independence, democracy, unity and prosperity' as expressed in the Lao constitution.

The study has demonstrated that the government plays diverse and active roles in various aspects of macro and sectoral economic management. The first major role of the government is to promote institutional reform especially in monetary and financial aspects in order to smoothly facilitate the development of a market economy under the Lao condition and to be able to integrate into global competition. At the same time, the government can administer market-friendly macro economic policies, in order to maintain the domestic economy under sound and stable conditions. It is also urgently needed to design a long-term plan concerning public investment. Another important role of the government is to play an active role towards development of industries with potential comparative advantages, as well as towards the development of a market economy itself. Furthermore, the government has a commitment to promote policies that are credible to Lao people and the outside world.

Under the strong pressure of regional and global competition, it is exceptionally important to find and promote a Lao way of development planning. This is exemplified as the *thamasaat* way of agricultural and rural development in the report, which is the basic message underlined in the study. We hope that the findings and policy recommendations of the study will to some extent contribute to formulating the development plan by the Lao government, even though the scope of study is rather limited.

We express our sincere gratitude to JICA, for supporting our study entitled Macro Economic Policy Support for the Socio-economic Development in the Lao PDR, for the two-year period from April 2000 to June 2002.

Thongloun SISOULITH

President
Committee for Planning and Cooperation

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1. Roles of Government in Transition, Global Integration and Economic Development in Lao PDR

Yonosuke Hara

1－1 Three Challenges

The transition is a socioeconomic occurrence in which a planned economy is gradually replaced by market economy. Its main issues are: to establish legal right of property-ownership; to liberalize domestic economy extensively; to introduce laws and systems that are compatible to market economy; to privatize state-owned enterprises; to dissolve collective farms; to develop private enterprises; and to reform monetary and fiscal systems. Laos used to adopt centrally planned economy and state-owned enterprise system, even though for a short period of time. The transition from these "old" systems poses various pressing issues.

The global integration means that a country opens its domestic economy to foreign countries in the aspects of trade, investment and finance, thereby inviting powerful external stimulation towards reforms. At the same time, it means that the country is incorporated into the global economic system of the times. Important policy decisions in this field include the content, speed, and order or sequence of participation in free trade, invitation of direct investment, and opening of foreign finance. During the age of planned economy, Laos was separated and isolated from the dynamic regional economic zone of East Asia, which was, no doubt, greatly responsible for the lagging economy of Laos. The global economic integration is an impending issue for the Lao economy.

The economic development denotes the dynamic process in which productivity-income increases and economic structure is upgraded and diversified. This process is the most classic economic issue with which any developing country is confronted. It is typically the process of a transformation from a traditional agricultural society to a modern society that is based upon industrial might. The matters of main concern about economic development refer to the issues directly related to people such as population control, education, income—differentials and finally poverty reduction. They also refer to the issues related to economic development such as agricultural development, infrastructure improvements and the issues related to resources mobilization such as savings & investment, and labor movement between agriculture and industry. Furthermore, the key question must be about development of social stratum of industrialists who will be able to uphold industrialization. In Laos, the fundamental and long-term issue indeed lies in the development. Unless the prerequisites to development are ready, the transition and global economic integration will be distorted to a great degree, or not be possible.

There is no doubt that the above three processes of transition, global integration, and development are intricately intertwined. What roles should the Government of Laos play in these diverse issues? The first major role of the Government is to promote institutional reforms towards the transition to market economy in monetary and financial aspects and at the same time to administer market-friendly macro-economic policies to maintain the domestic economy in sound and stable conditions. Furthermore, for the purpose of economic development in the wave of global economic integration, it is necessary for the Government to design a long-term plan concerning public investment. At the same time, it is also necessary to play an active role towards the development of the industries having the potential comparative advantages, and of the market economic system itself. This market-enhancing role is another important role of the Government. Anyhow, the Government should make all policies the credible commitment towards Lao people and the outside world.

1－2 Participation in ASEAN

Laos has obtained an opportunity to participate in a dynamic economic network surrounding Asia through its participation in the ASEAN. It can now introduce capital from the global market. At the same time, it is now become easier to receive technical transfers from foreign countries. Moreover, the participation enables Laos to join in global markets. It can be said that the first condition has been fulfilled for the integration of Laos into the global economy. It is manifested, for instance, in the mid-1990s by the activated production of motor-bicycle assembly and sewing industry for exports through the inflow of direct investment from the surrounding countries, particularly Thailand.

Especially, it is of great importance that Laos has paved the way for receiving cooperation from international society towards the development of the entire Indochina Peninsula through its reinstatement as a formal member of international society. It is particularly significant that Laos is now able to avail itself within Greater Mekong sub-region development plan. In the plan, Laos, which is located in the center of the Indochina peninsula, or a so-called "land-bridge", is positioned as an important point of transportation from every direction within the region. More specifically, it is indeed critical that Laos can now more readily receive loans and technical assistance from the Asian Development Bank (ADB) and other organizations for its infrastructure improvements including roads passing through Laos such as national highways No. 9 and No. 13.

However, at the same time, we cannot play down the fact that Lao has many powerful competitors. In addition, we should not disregard the fact that its participation in the ASEAN Free Trade Area (AFTA) has greatly shortened the remaining and preparing time before its integration with the global market. Laos faces an extremely difficult constraint to develop several industries up to the level of having the international and regional competitiveness by the year 2008, when in principle its tariffs must be lowered to the range of 0-5% for all imported commodities.

Through economic liberalization at its national boundaries and the transition of domestic economy to market economy, Laos has already participated in the Asian network. As a result, Laos is utterly susceptible to influences from economic fluctuations in its surrounding nations, which poses a serious problem to the development of Laos. Its susceptibility is concretely manifested by the fact that exports to Thailand have been decelerated due to the currency crisis of Thailand in the latter period of 1997. Simultaneously the import costs of raw materials from Thailand have drastically increased, which is a great blow to the sewing industry of Laos.

Undoubtedly Laos now confronts substantial difficulties in diverse aspects stemming from its participation in the Asian network. Particularly, it is necessary to prepare carefully the participation in the AFTA. Even though the cost of joining AFTA is painfully dear to Laos for the time being, it is apparent that there can be no effective developmental strategies for Laos except for deepening its participation in the Asian network while overcoming such difficulties each by each.

1－3　Fundamental problems of Lao economy

The growth target set by Lao government in its Socio-economic strategy for 2020 seems to be a little bit ambitious. Of course, the policy target of the Government to catch-up the neighboring-countries as soon as possible is understandable. However, in the contemporary days of the economic globalization, careful utilization of unique characteristics, in other words comparative advantage, of Lao economy and ecology is more meaningful and efficient in the long run, as compared with the mere catching-up of per-capita income.

Fundamental problems of Laos can be summarized as follows.

First, domestic economic regions are not unified due to lack of infrastructure in transportation and communication. Laos is a nation that is topographically segmented, and many regions are still in a stage of subsistence economy that is not adequately incorporated into market economy. Its domestic commerce and market network has not been adequately formed, and institutions are not sufficient for the unification of its domestic market.

Second, Laos is sparsely populated nation, although it is growing rapidly. As a result, the labor is not the abundant resource in Laos. The level of wages is not significantly lower than the neighboring countries such as Viet Nam, Cambodia, Myanmar and China. This fact implies the very crucial fact that any strategy based upon utilization of abundant labor will not be suitable to Lao PDR at least for the coming decade.

Third, its population composition is skewed towards a high proportion of children, which reflects a high population growth rate. The literacy rate of the population still remains low. For this reason, human resources are not amply available to uphold the activity of market economy. Additionally, Laos is a multi-ethnic nation with a number of small ethnic groups, which is another factor to hamper the unification of its domestic market.

Based upon the above problems of Laos, the most fundamental challenge of Lao economy does not lie in the transition from socialistic system to market economy, even though several negative legacies of the old system still remains. Rather, it is the very development in which its domestic economy grows from subsistence economy or segmented and divided market regions into one domestically integrated market economy. Laos is at a transitional stage to market economy, but its real situation is nothing but a developing country at a low level of development of market economy. It is, therefore, necessary for us to clearly recognize the fact that the phase of a high economic growth solely through economic incentives offered by New Economic Mechanism, exemplified in the early 1990s, has gone already.

In promoting the long-term development of Laos, it is essential to improve such physical infrastructure as transportation system to connect local populations that are sporadically divided. It is also imperative to enhance the quality of human resources through expanding primary education and strengthening health and medical system. Public investments should be concentrated on these aspects for the time being. It is indispensable for economic development of Laos to take the course in which people living in diverse ecosystems gradually accommodate themselves to market economy while taking environmental conservation into serious consideration. In any event, it needs to be emphasized that Laos faces the challenge of development that is more difficult than the transition from planned economy to market economy.

1 — 4 Issues at the macro-Level

The final objective in the present development plan of Laos is to take-off from the least-developed country by the year 2020. To that end, around 7% of GDP growth is set as the target.

In order to materialize this growth-target, it is required to have investments at the ratio of 25-30% vis-à-vis the gross domestic product. The ICOR is estimated at around 4. This assumption regarding to ICOR is not so unrealistic in that Laos still remains at a stage that unquestionably needs public investments for its infrastructure. A question is whether capital can be supplied to satisfy the requirement for such a massive amount of investment that is disproportionate by high to its domestic economy. Briefly stated, it will be absolutely necessary to finance the greater portion of the required investment-capital by foreign aid and also foreign private investment including through BOT.

Indeed, foreign aid has been increasingly expanding to the extent that approximately 55% of its public investment in FY2001-2002. Donor country or donor organization provides its foreign aid, based upon the premise that Laos is very important as the land-bridge of the Indochina peninsula. The main concern here is the capacity of Lao PDR government to absorb efficiently such foreign aid. Rapid and continuous enlargement of public investment financed by foreign assistance should require increase of current expenditure by the Government both at the central and local levels.

The basic problem then lies in the possibility whether domestic savings can be efficiently mobilized or not. As of now, the ratio of private savings vis-à-vis GDP is approximately 10%. Even with the addition of governmental savings, the total ratio slightly exceeds 10%. The decisively important point for the future of the Lao economy is whether the ratio of private savings, rather than governmental savings, will increase or not. Consequently for the development of Laos, it is vital that domestic savings will flow smoothly and effectively into the sector of production through upgraded intermediation-capabilities, to absorb the deposits and extend the credits, of the domestic banking sector. The mechanism of financial intermediation should be institutionally strengthened.

The Government's budget revenues still remain less than 15% to GDP. Sharp drops in tariffs due to ratification of AFTA: difficulties in tax collection from foreign corporations due to small profit tax rates to induce foreign direct investment: enlarged expenditures caused by an increased number of development projects: fiscal issue is very real in Laos. In view of these problems, it is urgent for Laos to overcome, as quickly as it can, shortfall of tax receipts caused by the existing inadequate tax regulations and taxation system. Laos faces the serious dilemma of expanding the tax base without depending upon customs duties. If it fails to secure budget revenues, it will face another critical problem that budget deficits will expand, thereby accelerating inflation.

The current account deficits pose another serious problem as well. It has reached roughly 15% to GDP. Under present circumstances in which domestic savings cannot be efficiently mobilized, increased domestic investment will result in widening deficits in balance-of-payments. Therefore, adequate precautions must be taken to the issue of foreign debt management. If Laos is too much dependent upon foreign resources especially official aids, it increases the danger that its foreign debt management will be strained, because now it has no other promising export industries than electricity and lumber.

The most fundamental issues of macro-economic management are to reduce the budget deficit and keep its local currency and financial conditions sound. Only when these prerequisites are maintained, Lao people will trust and approve market economy and economic policy of Government. The Government should manage its macro-economy policy in a "market-friendly" manner.

1－5 Reforms in the economic system

As prerequisite for establishment of efficient market economy, it is necessary to enhance tax-bases and efficiency of tax-collections, in order to curb widening of the budget deficits. In the banking sector, it is required to separate systemically the central bank and commercial banks and to strengthen the financial intermediary functions of commercial banks. In the near future, it will be necessary to develop TB market, so that the central bank can effectively enforce financial policies such as open market operations.

With respect to exchange-rate policy, Laos faces the serious problem of how to keep balance between stability, which is a prerequisite for inflow of foreign capital and flexibility for strengthening and maintaining export competition. In 1998 and 1999, the budget deficits were compensated by increased money supply through the central bank, thereby accelerated inflation and caused sharp drops in exchange rates. Such incongruous management of macro-economic policies should be redressed. It will be necessary to have mix of the healthy money supply management and the exchange rate regime of keeping stability. Furthermore, it is an impending issue to establish the appropriate system of foreign debts management.

1－6　Issues at the industrial level

Based upon the current developmental conditions of the Lao economy, the Government needs to perform more positive market-enhancing role beyond market-friendly macro-economic policy. We shall briefly discuss some problems for each sector to clarify the subject.

(1) Agriculture and Rural Development

Agricultural and rural development is undoubtedly the basis of economic and social development in Laos where the majority of people lives in the rural areas. In the agricultural development of Laos, the most effective policy instruments will be to conduct agricultural experiments and researches on the improvement of crops that can be produced even in rain fed fields, and to build small-scale irrigation systems in the regions of plains and mountain foots. Particularly, with respect to the small-scale irrigation systems, the first priority should be given to establishment of organization and institution of maintaining the existing equipments. Especially the special attention should be paid to the fact that most irrigation facilities constructed after 1997 have not been well operated and facing many problems. It is highly possible that the dry season irrigated areas will decrease and then rice-production might decrease. Food-security issue should be seriously considered once again.

Development of agriculture, as well as forestry, has not been even between the lowland and upland. In the upland area of the northern Lao, the most effective way of development is to establish the appropriate farming system based upon the each area's specific ecological condition. Uniform way of introducing the modern farming system to every area is not efficient. Gradual development of the existing thamasat farming systems through utilizing the elder and veteran farmers' knowledge will be the most effective strategy of agricultural development in the upland region.

In the lowland of the Mekong corridor, cash crops and livestock industry should be at the center of development planning. Here identification of the commodities with the export-competitiveness is urgently needed.

(2) Manufacturing industry

When taking seriously into consideration the small size of both population and domestic market, it can not be appropriate for Laos to employ the strategies of industrialization such as export-oriented or import substitution based on labor-intensive products which other ASEAN countries has adopted.

Instead, the strategies to use the existing local resources and techniques will be most effective for Lao industrialization. One of promising examples is rural hand-weaving industries and its related sectors such as sericulture, cotton growing and spinning as well as silk reeling industries. It is also urgently needed to investigate the developmental possibility of small-medium size industries in various fields.

(3) SOEs and FDI

Institutional reform of providing the healthy conditions for private foreign investors is very important. However, it is more crucial to understand the real situation of Lao economy in the Asian regional and global context. Also it is highly important to harmonize the strategy for FDI with reforms of State-owned enterprises (SOEs).

(4) Sightseeing industry

Premised upon the ecological conditions of Laos, it will be possible to enhance ecotourism in diverse regions.

(5) Infrastructure and Environment

As long as the biggest challenge of development is to form a unified domestic market, it is obviously indispensable to build such infrastructure as roads, transportation, and communication. Geographically speaking, Laos is situated at the land-bridge in Continent Southeast Asia. It is, therefore, required to improve its infrastructure in coordination with broader wide-area infrastructure improvement plans, for instance, the Greater Mekong sub-regional plan. At the same time, Lao government should pay more attention to the operation and maintenance costs of the newly-developed infrastructure and their implications to the Government budget. Moreover, it should be emphasized that development plan relying on the excess-supply of social overhead capital has so often failed in many countries, especially when the potential demand for it from the private direct production sectors.

In addition, at the time of building international highways, zoning should be appropriately made so as not to destroy the means of living of local people. It is also critical to prepare related regulations to avoid the depletion of forests caused by random commercial lumbering or improper tree planting due solely to easier access. Moreover, it is vital for Lao Government to strengthen the capabilities to carry out monitoring and formulate detailed rules concerning the enforcement of its regulations in order to heighten their practical effects.

(6) Human resources development

Laos has very high population growth in Southeast Asia, which is evidenced in its population composition with a very large proportion of children. Considering the feature of the Lao population, definitely important are primary education and health-care measures for the economic and social development of Laos.

To raise the governance capability of the Government and modern sectors, including banks, it is required to develop human resources with higher qualifications. Vocational training, in the fields of electric work, repairs of electric appliances, employment in hotels, etc., and business practice, will exert a great deal of influence upon the economy as well.

Also, it is urgently needed to upgrade the Government's capability of making government's capability of making macro-economic and developmental policies, including gathering and processing the socio-economic data.

(7) Government's Active Roles towards Development

As can be seen in the above, the Government should perform diverse and active roles in the development of each sector. The Government must plan and implement public investment in line with each sector development plan. With the serious constraint in fiscal resources, it becomes indispensable for the Government to formulate long-term strategies and plans for the distribution of public investment.

Furthermore, the Government needs to play an assertive role for the sound development of market economy. Major issues are to prepare legal systems for market economy and to develop various institutions to support the market economy. In this perspective, the "market-enhancing role" of Government is very important. The Government should maximize its efforts to make its announced policies the credible commitment to Lao people and the outside world.

2. Macroeconomic Perspective and Policy Issues

Kenji Domoto

This chapter and the next chapter, with respect to the macroeconomic sector and the financial sector respectively, intend to clarify the locations of issues to be examined and the directions for policies to be considered. Needless to say, the fiscal sector and also financial sector contain inseparable debates from issues in the macroeconomic sector. Bearing this in mind, first of all, fundamental tasks for the sustainable growth of the Lao economy as a whole will be pointed out from movements of macroeconomic indexes. Furthermore, confirmation will be made on an ideal way of fiscal management that is the condition for overcoming those tasks, favorable directions and questions at issue.

2－1 Current Situation

2－1－1 Overall issues

Lao PDR is a landlocked, largely mountainous country of around five million people and covers an area of 236,800 km^2. The country is characterized by ethnic, cultural, and linguistic diversity. About 60% of the country is estimated to be covered with dense tropical forest. With an estimated GDP per capita of below US$ 400, and nearly half of the population below the poverty line, it is one of the least developed countries of the world. The economy is characterized by a largely subsistence oriented agriculture with a very low level of monetization, a weak human resource base, and a small exporting sector consisting mainly of natural resources products. Combined with forestry, agriculture accounts for around half of GDP (51%).

In contrast to many other low-income countries, Lao PDR is well endowed with natural resourses. It has untapped reserves of agricultural land, large forest, hydropower potential, and mineral resources that, when efficiently exploited, could contribute substantially to economic progress. However, the country also faces serious disadvantages. Its landlocked position, rugged terrain, low population density, and widely dispersed settlements generate high transportation and communication costs and render broad, equitable improvements in social and economic infrastructure expensive.

Since the introduction of reform under the New Economic Mechanism (NEM) in 1986 with the support under the IMF's structural adjustment facility (SAF), a World Bank's adjustment credit (SAC), and a program loan from ADB, considerable progress has been made in macroeconomic stabilization and structural adjustment. A market based price system has been established and the currency floated according to market's law. Foreign investment regulations are among the more open in the region, and trade barriers are relatively low. The gradual introduction of a regulatory framework to support private sector activity and the introduction of more attractive foreign investment legislation led to increased foreign investment inflows in the mid 1990s. GDP growth averaged 7% during 1988-1996 but since 1997, the regional economic crisis has reversed the direction.

However, in the longer term, Lao PDR has many advantages to growth further. It shares borders and many common interests with Thailand, Viet Nam, Cambodia and China, forming what many see as a natural economic growth area of the future.

Lao PDR's extensive and largely untapped natural resource base and its geographic location places it in a position to benefit from a return to regional prosperity. While the small size of the domestic market limit opportunities for trade with Laos, the more than 100 million people who live within 100km of its borders will generate market opportunities. Besides, the Lao PDR has the potential to become an important overland transit point for trade in the Mekong region and between South-East Asia and the Chinese and East Asian economies.

It could also become a supplier of commodities to fuel economic development in its neighbors, particularly in the fields of energy production and mining. Many countries in the region have been expanding their commercial links with Laos in recognition of those opportunities.

2－1－2 Recent Economic Performance

Starting from mid-1997, due to the external shock : the Asian Crisis the reform momentum has been slowed and the macroeconomic environment has deteriorated considerably, with inflation running at triple digit levels, and exchange rate depreciation reaching alarming levels. From June 1997 to June 1999 the Kip lost around 87% of its value and reached a crisis point in September 1999 when it fluctuated widely, falling from 3,500 kip to the dollar to 9,000 kip to the dollar in a matter of weeks.

However, the negative impact of the crisis on gross domestic product (GDP) growth was limited. The country's dependence on subsistence agriculture and its relative lack of integration into the global economy had insulated it somewhat from the crisis. In 1998, growth slowed to 4% and 7.3% in 1999 and is estimated to be 5.9% for the year 2000.

By mid-2000, the Lao economy had stabilized after two years of macroeconomic instability spurred by the regional economic crisis in Asia. Downward pressure on food prices resulting from a series of good rice harvests coupled with a more stable currency has contributed towards falling inflation. Average inflation in 1999 was 145%. However, from August 1999 to September 2000, monthly inflation averaged less than 2%/month, after reaching triple figures earlier this year. During the same period, the Kip has been stable at around 7,500 kip to US$ one, a level 20% stronger than at the end of June 1999. In brief, Lao real GDP growth did not suffer nearly as much as many other neighboring countries especially the Asian group (Table 2 — 1). But one has to recognize that the situation has worsened and for a country as poor as the Lao PDR, even relatively small changes in social conditions and living standards are cause for concern.

Table 2 — 1 Comparative Real GDP Growth Rates (%)

	1996	1997	1998	1999	2000*
Lao PDR	6.9	6.9	4.0	7.3	5.9
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

* Forecast

Sources: Discussion Paper: Macroeconomic Framework, August 2000 Round Table Process 2000-2002, page 14.

2 — 1 — 3 Industrial structure

While agriculture occupies a predominant sector in the economy, industry and services account only for a growing share of GDP (21% and 26% respectively). Tourism is taking a run up with the Government's tourist campaign "Visit Laos Year 1999-2000". Key industrial activities are electricity production, garments, handicrafts, foodstuffs, chemical production and mining etc.

Growth in Lao PDR since the beginning of the reform process in the mid-1986 has been unevenly distributed between economic sectors. The NEM has boosted growth in the industrial sector and the private sector while it has only marginally effected growth in the agricultural sector.

Manufacturing is the largest industry subsector (16.5% of GDP in 1999 compared to around 9% in 1990). But manufacturing is not very diversified in Lao PDR. The food processing industry (rice milling, beer and soft drink production, etc.), the garment industry, cigarette production and wood processing account the lion's share of the sector. Since the start of the reform process, manufacturing outputs have experienced varying evolutions, with the very expansion of relatively more labor intensive manufacturing like garments. During the same period, the second largest industry subsector, construction (around 2.6% of GDP in 1999), achieved a much lower rate of growth, electricity and water (around 2.3% of GDP in 1999) shows a roughly similar growth rate albeit more variable. Finally, the smallest industry subsector, mining & quarrying (around 0.5% of GDP in 1999) exhibited the fastest growth from last year.

The structural changes that have occurred in Lao PDR as a result of the NEM have affected mainly industry and the service sectors. Contrary to industrial structures of other advanced ASEAN's countries, Lao industrial industry sector still remains a primary industry sector.

The advancement of ASEAN industrial structures can be viewed from the following two perspectives. First, there is a trend towards industrialization, which is a shift from primary to secondary industries. Two, indicators of the change are the percentage contribution of secondary industries to GNP, and manufactured goods as a percentage of total export (the manufactured export ratio). The second perspective is the shift from labor-intensive to capital and technology-intensive industries in the manufacturing subsector. Thailand and Malaysia, where their manufactured export ratios are over 70%, and where the machinery industries show a large share of exports. Indonesia and the Philippines, where industrial structures are somewhat based on primary and light manufacturing such as textiles, although machinery industries are starting to develop.

2 — 1 — 4 Balance of payments

Normally, Lao PDR has a relatively large trade deficit. But since 1996 the deficit started to fall from 19.9% of GDP to 14% of GDP in 1999 due to the contraction of import. During the period of 1998-2000, in absolute value the trade deficit stayed roughly stable (Table 2 — 2). The current account deficit has been even smaller than the trade deficit. Trade and current account deficits direction indicate there is a declining inflow in the capital account since 1996.

As far as the debt issues are concerned, indicators shown in Table 2 — 3 reveal that starting from 1998 total debt service as percent of GDP and export of the Lao PDR are respectively 4.3% and 15.2% reached respectively 4.3% and 21% in 1999. Having a debt service as percent of GDP in excess of 4% and a debt service as percent of export above 18% is a warning indication that Lao PDR may have a problem to service its debt in the future. Besides, external debt as percent of GDP data of the Lao PDR for 1996, 1997, 1998 and 1999 provided by the IMF (Selected Economic Indicators: Article Consultation with Lao PDR, 1999) are respectively 43.5%, 55.9%, 87.6% and 90% which are rather high.

Table 2 — 2 Lao trade balance and current account deficit

	1992	1993	1994	1995	1996	1997	1998	1999	2000
GDP (Million USD)	1174.1	1315.3	1542.1	1754.0	1855.8	1730.1	1201.0	1527.4	n.a.
Export (Million USD)	132.6	247.9 (87%)	305.4 (23%)	346.2 (13%)	321.0 (-7%)	317.0 (-1%)	341.0 (8%)	310.9 (-9%)	323.0 (4%)
Import (Million USD)	253.0	431.9 (71%)	564.1 (31%)	588.8 (4%)	690.0 (17%)	648.0 (-6%)	553.0 (15%)	524.6 (-5%)	540.0 (3%)
Trade Balance (Million USD)	-120.4	-184.0	-258.7	-242.6	-369.0	-331.0	-212.0	-213.7	-217.0
As % of GDP	10.2	14.0	16.8	13.8	19.9	19.1	17.6	14.0	n.a.
CAD (Million USD)	-104.5	-146.0	-263.7	-200.0	-30.2	-282.0	-128.5	-145.1	n.a.
As % of GDP	8.9	11.1	17.1	11.4	16.5	16.3	10.7	9.5	n.a.

-Figures in parenthesis indicate growth,

Sources: Discussion Paper: Macroeconomic Framework, August 2000 Round Table Process 2000-2002, page 13.

Table 2－3 Debt of the Lao PDR

	1992	1993	1994	1995	1996	1997	1998	1999	2000
GDP (Million USD)	1174.1	1315.3	1542.1	1754.0	1855.8	1730.1	1201.0	1527.4	n.a.
Total Debt Services (Million USD)	n.a.	n.a.	4.5	6.2	5.0	37.1	51.9	65.1	n.a.
Total Debt Service as % of GDP	n.a.	n.a.	0.34	0.35	0.32	2.14	4.3	4.3	n.a.
Total Debt Service as % of Export	n.a.	n.a.	1.5	1.8	1.8	11.7	15.2	21.0	n.a.

Sources: Calculation based on data provided in the Discussion Paper: Macroeconomic Framework, August 2000-Round Table Process 2000-2002, page 14.

2－1－5 Policy issues for steady economic growth in coming year

Until the onset of the regional economic crisis in mid-1997, the process of structural reform and economic liberalization in Lao PDR had brought increased prosperity to the urban population at least and led to increased activity in the small but growing private sector. While the reform process was still incomplete, changes had opened up areas of opportunity for foreign trade and investment. The economic reform agenda now sits stalled in the wake of the economic crisis and domestic weaknesses in the economy will need to be remedied if the Lao PDR is to proceed on the path of sustainable economic growth.

The speed of recovery in East Asia, particularly Thailand, continues to be an important determinant of the Lao PDR's medium term economic prospects but domestic reform will also be critical. Significant structural impediments to the economic development of Lao PDR remain, including inadequate physical infrastructure and undeveloped human resources.

The achievement of strong growth rates in the future require sustained commitment of the Government to ensure macroeconomic stability and improving economic management. Improving and strengthening institutional arrangements will be an important part of the process. A number of key areas that require attention include recapitalization and reform of the highly indebted financial sector; reform of state-owned enterprises, better management of foreign exchange transactions; greater capacity for increased revenue collection and greater collection and publication of economic information. Economic stability will also depend more generally on further progress in promoting private sector activity, increasing domestic savings and improving resources allocation.

2－2 Long-term Perspective

2－2－1 Review of the past development

As described in the preceding section, viewed from a long period of time, there is a possibility of economic development in Laos. Today, civil and building construction techniques and communications techniques are remarkably developing and international fund transfers are active. Her geographic condition of being surrounded by countries with highly growing potentials is now looked upon differently, unlike in the era when the handicap as an inland country was considered to be insuperable constraints for economic development. The possibility for the development of Lao economy is being internationally focused and earnestly discussed.

But, as the following studies will gradually clarify the situation, in order to materialize the expectation for such a long-term growth, among issues involved in operating the economy in Laos, there are many problems that are extremely difficult for solution in a short period of time. These affect one another and are presumably not such types that picking a knot apart will automatically unknot others.

Even considering over a long period of time, unless Laos steadily solves questions at issue, there is a great possibility that it will fall into an extreme difficulty from a viewpoint of preparing the basis for economic development and from the standpoint of short-term and medium-term macroeconomic management.

(1) Time-series variations in GDP components

Table 2－4 compiles structural transformations (variations in GDP component ratios) for each country of ASEAN except Brunei from 1970s on. Here, two points will be pointed out.(Table 2－4)

Firstly, there is a point one mentions at times. That is, in the case of countries with their per capita income levels already exceeding Laos, many of those countries might have experienced from 1970s to 1980s not only changes in GDP component ratios but also, on the back of it, severe structural transformations. The figures themselves in this table merely indicate sector-specific component ratios of GDP. By experience,

Table2 − 4 GDP composition of ASEAN member countries since the 1970

(%)

Thailand

	1970	1980	1990	1999
Agriculture	26	23	12	13
Industry	25	29	37	40
(Manufacturing)	16	22	27	32
Service	49	48	50	49

Philippines

	1970	1980	1990	1999
Agriculture	30	25	22	17
Industry	32	39	34	31
(Manufacturing)	25	26	25	21
Service	39	36	44	52

Indonesia

	1970	1980	1990	1999
Agriculture	45	24	19	20
Industry	19	42	39	45
(Manufacturing)	10	13	21	25
Service	36	34	41	35

Malaysia

	1970	1980	1990	1999
Agriculture	29	22	19	14
Industry	25	38	40	44
(Manufacturing)	12	21	26	35
Service	46	40	41	43

Singapore

	1970	1980	1990	1999
Agriculture	2	1	0	0
Industry	30	38	35	36
(Manufacturing)	20	29	27	26
Service	68	61	65	64

Vietnam

	1970	1980	1990	1999
Agriculture	…	…	37	26
Industry	…	…	23	33
(Manufacturing)	…	…	19	…
Service	…	…	40	42

Cambodia

	1970	1980	1990	1999
Agriculture	…	…	56	51
Industry	…	…	11	15
(Manufacturing)	…	…	5	6
Service	…	…	33	35

Myanmar

	1970	1980	1990	1999
Agriculture	…	…	57	53
Industry	…	…	11	9
(Manufacturing)	…	…	8	6
Service	…	…	32	38

Laos

	1970	1980	1990	1999
Agriculture	…	…	61	53
Industry	…	…	15	22
(Manufacturing)	…	…	10	17
Service	…	…	24	25

Low and Middle Income countries

	1970	1980	1990	1999
Agriculture	25	…	16	12
Industry	33	…	38	35
(Manufacturing)	…	…	23	22
Service	42	…	46	54

Source: World Bank, World Development Report, 1993, 1997, 2000/2001
Remark: "…" denotes "data is not available"

however, it is no exaggeration to say that the behavior of transportation, communication, distribution and financial markets is distinctly different between the economy where the manufacturing industry has a share of 10 % in GDP and the economy in which it is 20 % or more. Theoretically, the greater the production scale of manufacturing industry, the larger the scale of demand for investment funds. Thus, an efficient capital market will be needed and the quantitative and qualitative demand for infrastructure will grow far greater amid the increase in density related to industries including agriculture. Unless such demand can be smoothly met, the economic development as a whole is impossible.

Secondarily, related to this, there is a point desired to be mentioned. That is, an extremely small share of the service industry of Laos. Now, some figures in the table are compared. The service industry of Laos is smaller than that of any other country since 1990s when data become complete. Besides this, what attracts attention is that in comparison with the scale of manufacturing industry of Laos as of 1999 (its share of GDP was 17%), similar scales in other countries as of 1970 were far smaller than the above, namely, Thailand (16%), Indonesia (10%) and Malaysia (12%). However, the shares of their service industries were 49%, 36% and 46% respectively. This is far greater than today's share of 25% of the service industry in Laos.

The table is simple and that the figures are in a series of nominal prices. For this reason, naturally there is the need to pay great attention when an international comparison is conducted with respect to changes for a long period of time in components. Perhaps one should be more mindful of the two points mentioned here than the way of interpreting statistical data. In other words, the share of the service industry which is composed of transportation, telecommunication, wholesalers, retailers, monetary services, real estate and tourist industry and supporting the active transaction of goods and services has remained intact at around a quarter of the economy for the past ten years. On the contrary, a point is whether such a change in the manufacturing industry as the 7-point rise from 10% to 17% is possible in the future.

Perhaps this seems to be very difficult in comparison with the experience of other countries with relatively large service industries. Probably this is attributable to the socialistic operation of the economy in the past. Suppose an attempt is made to continue structural transformations for a long period of time by smoothly expanding direct production activities such as manufacturing industries and agriculture and to find out a route thereof. Then, a question is that it will be indispensable to perfect the service industry one way or the other (that is, maintaining a macroeconomic balance) from institutional, organizational, human resources and materials viewpoints. Sustained efforts should be concentrated on this point.

Next, these mentioned here will be discussed a little more definitely by combining them with macroeconomic growth and development.

(2) Investment, Efficiency, and Saving

1) Investment efficiency

We know that there is a famous economic development model although it is very simple but instructive for substantial matters concerning the relation between an investment ratio and an economic growth rate. The formula is known as Harrod-Domar model. It once performed a role to show a policy implication to the effect that a high economic growth rate could be realized by raising an investment ratio. This is incredible nowadays.

The discussion here, however, will be put forward, using the original form of this model. The reason is to draw out a long-term economic perspective for the Lao economy in the simplest form. Then, it will be compared with other countries in the same framework to grasp in what levels of issue the targets are, which should be overcome in Laos, and of what components the contents of those targets are composed. To begin with, relations between economic growth rates and investment ratios recorded in developing countries in the world and their relations with investment efficiency will be briefly confirmed. Needless to describe in detail, the following basic formula shows that an economic growth rate is the product of a macroeconomic investment ratio and investment efficiency 〔In this case, it is an inverse number of Incremental Capital Output Ratio (ICOR)〕.

$$\triangle Y/Y=[I/Y] \times [\triangle Y/I]$$

Y: Gross Domestic Product, I : Domestic Investment, △ : Increment

In using this framework, there is the need to take note of one point. Originally, ICOR is calculated on the basis of capital stock data. In many developing countries,

Table2 — 5 Growth rate, Investment ratio and ICOR (1980-1990)

	GY(%)80/90	I/Y(%)80/90	ICOR80/90
1 . China	10.2	36.5	3.6
2 . Korea, Rep.	9.4	31.0	3.3
3 . Thailand	7.6	28.5	3.8
4 . Hong Kong, China	6.9	31.5	4.6
5 . Singapore	6.6	41.5	6.3
6 . Pakistan	6.3	18.0	2.9
7 . Indonesia	6.1	23.0	3.8
8 . India	5.8	22.0	3.8
9 . Egypt, Arab Rep.	5.4	24.0	4.4
10 . Turkey	5.4	21.0	3.9
11 . Malaysia	5.3	28.0	5.3
12 . Nepal	4.6	19.0	4.1
13 . Burundi	4.4	16.0	3.6
14 . Lesotho	4.4	45.0	10.2
15 . Bangladesh	4.3	17.0	4.0
16 . Chile	4.2	19.0	4.5
17 . Kenya	4.2	27.5	6.5
18 . Morocco	4.2	24.0	5.7
19 . Japan	4.0	31.5	7.9
20 . Sri Lanka	4.0	28.5	7.1
21 . Chad	3.7	7.5	2.0
22 . Burkina faso	3.6	21.0	5.8
23 . Colombia	3.6	20.0	5.6
24 . Zimbabwe	3.6	19.0	5.3
25 . Israel	3.5	19.5	5.6
26 . Australia	3.4	24.5	7.2
27 . Cameroon	3.4	19.0	5.6
28 . Canada	3.3	22.5	6.8
29 . Congo, Rep.	3.3	29.0	8.8
30 . Finland	3.3	28.0	8.5
31 . Tunisia	3.3	24.0	7.3
32 . Ireland	3.2	22.5	7.0
33 . Uganda	3.2	9.5	3.0
34 . United Kingdom	3.2	19.0	5.9
35 . Dominican Republic	3.1	24.5	7.9
36 . Portugal	3.1	32.0	10.3
37 . Senegal	3.1	13.5	4.4
38 . Costa Rica	3.0	26.5	8.8
39 . Spain	3.0	23.0	7.7
40 . United States	3.0	17.5	5.8
41 . Benin	2.9	13.5	4.7
42 . Norway	2.8	28.0	10.0
43 . Algeria	2.7	35.0	13.0
44 . Brazil	2.7	23.0	8.5
45 . Honduras	2.7	20.5	7.6
46 . Jordan	2.5	31.5	12.6
47 . Malawi	2.5	20.5	8.2
48 . Paraguay	2.5	28.0	11.2
49 . Italy	2.4	25.0	10.4
50 . Denmark	2.3	18.0	7.8
51 . France	2.3	22.5	9.8
52 . Netherlands	2.3	20.5	8.9
53 . Sweden	2.3	20.0	8.7
54 . Austria	2.2	28.0	12.7
55 . Rwanda	2.2	16.0	7.3
56 . Belgium	2.0	20.0	10.0
57 . Ecuador	2.0	24.5	12.3
58 . Jamaica	2.0	21.5	10.8
59 . Switzerland	2.0	30.0	15.0
60 . Papua New Guinea	1.9	25.5	13.4
61 . Greece	1.8	25.5	14.2
62 . Mauritania	1.8	27.0	15.0
63 . New Zealand	1.8	21.5	11.9
64 . Poland	1.8	29.5	16.4
65 . Togo	1.7	24.5	14.4
66 . Nigeria	1.6	17.0	10.6
67 . Syrian Arab Republic	1.5	22.5	15.0
68 . Central African Repul	1.4	9.5	6.8
69 . Kuwait	1.3	17.0	13.1
70 . Ethiopia	1.1	14.5	13.2
71 . Madagascar	1.1	15.5	14.1
72 . Mali	0.9	15.0	16.7
73 . Guatemala	0.8	15.0	18.8

Source: World Bank, World Development Report, 1998/99 however, capital stock data are not available. For this reason, investment data and, what is more, data in which even stock data are included are applied as an approximation. This should be kept in mind. In attempting to clarify relations between stocks of a technical embodiment, that is, equipment and machines and long-term production activities, attention should be paid to the fact that there is the possibility to largely incorporate business fluctuations (variation in stocks) and appreciation is not taken into account. Other points of consideration will be mentioned in the following section.

Using data of the World Bank, there is a calculation on economic growth rates, macroeconomic investment ratios and ICOR of various countries, including 73 industrially advanced nations with perfect data for 1980 and 1990. This is given in the Table 2 — 5.

What will be immediately known from this table is that ICOR levels vary with countries to a considerable extent. A great difference is also seen in the level of investment ratios. Drawing two illustrations such as those shown below helps reflect

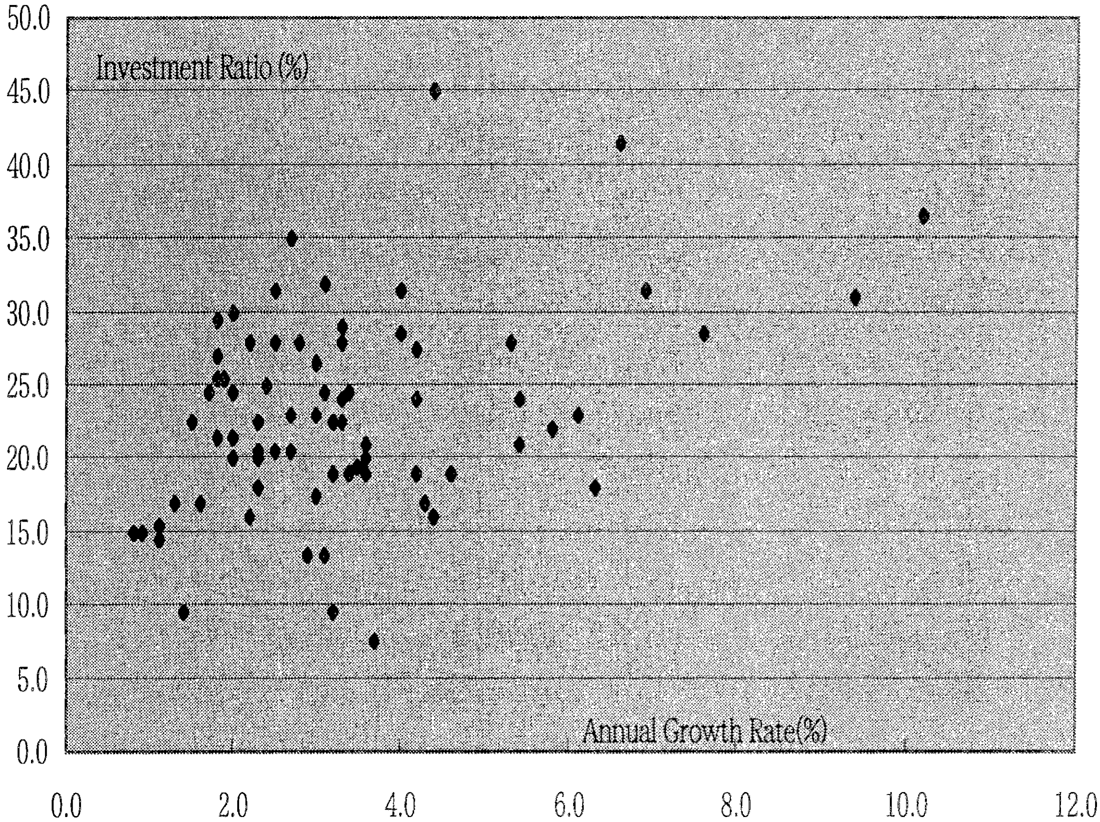

Figure2 — 1 Investment ratio and Growth Rate

Source : "World Development Report 1998/1998"

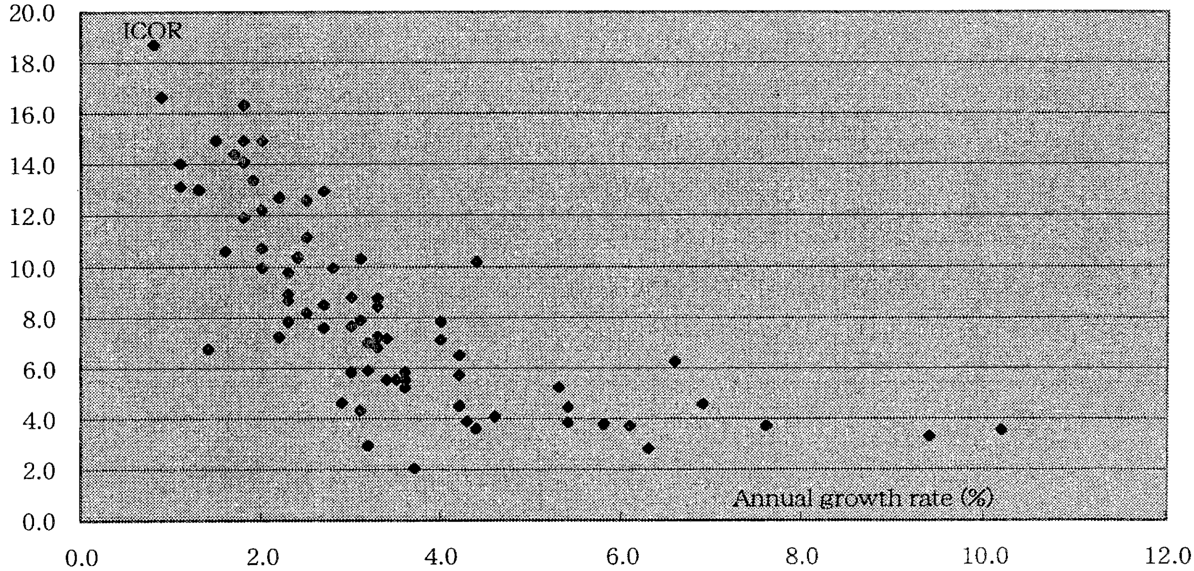

Figure2 — 2　ICOR and Growth Rate

Source : The same as Figure 2 — 1

actual pictures. That is, relations between actually recorded growth rates and investment ratios and those with ICOR as indexes of investment efficiency will be unfolding.

Using Table 2 — 5 as a material, Figures 2 — 1 and 2 — 2 are first intended to grasp visually relations between macroeconomic investment ratios and attained economic growth rates for each country and then relations between ICOR and growth rates.

It appears that there is a positive correlation between an investment ratio and a growth rate. Perhaps it can be called a slightly strong relation as a tendency. In short, a country realizing a higher investment ratio could attain a higher economic growth rate. As Figure 2 — 2 indicates, however, two variables, namely, the relation between ICOR and a growth rate is far definite, comparing with the relation between an investment ratio and a growth rate. In the Figure 2 — 2, it is obvious that the greater an ICOR absolute value which is taken on the vertical axis (towards further to the north), the lower a growth rate of the horizontal axis will correspond.

The conclusion thus drawn is that raising an economic growth rate may be possible by increasing an investment ratio. However, unless high investment efficiency is simultaneously combined, it may be impossible to realize a high growth rate. Now, back to Table 2 — 5. For instance, suppose a macroeconomic investment ratio is at a level of 20-25%, it is never a low investment ratio from an international point of view. The level is rather high. However, as it is obvious from the Table, fairly many countries including advanced nations remained low in the level of growth rates of the overall economy in 1980s due to low efficiency, though they realized a high investment ratio of around 30%.

Now, next questions are what degree of growth rate the Lao economy is aimed at and what degree of domestic investment rate it can anticipate. In the next section, these will be discussed. In addition, some components that are considered to constitute investment efficiency will be discussed on a case in Laos.

2) International comparison of investment efficiency

In the above discussion, ICOR levels and the dispersion of those levels among countries in the world except for Laos were confirmed. And, the discussion was made on the fact that investment efficiency varied with countries. Now, before examining what level of ICOR can be expected for Laos, let us refer to the transition of ICOR for a slightly longer period of time in the past on a limited number of countries. In other words, unlike the former discussions that intended a cross-section analysis, a simple time-series analysis will be made below.

Table 2 − 6, adopting Korea, Singapore, Thailand, Indonesia, Nepal and India as the targets for observation, summarizes their investment ratios, growth rates and ICOR movements.

When the movements in growth rates of these six countries from 1970s on are compared, how rapidly Korea, Singapore and Thailand have been growing can be appreciated all over again. In terms of the growth rate of each country in 1990s including the Asian economic crisis after 1997, though it has fallen quite a bit in some countries, in average the growing potential is still great. In 1990s (1990-1999), the average of GDP growth rates of low-income countries is 2.4% and that of middle-income countries is 3.2%, according to the "World Development Report 2000/2001" of the World Bank.

Some countries experienced a rapid economic growth from 1970s on as mentioned above. The rise of investment rates in the past was also remarkable. Singapore's 39% in 1970 is already conspicuous. Korea and Thailand recorded about 25%, others' investment ratios registering slightly above 15%, however, they marked a great rise in 1970s and throughout 1980s. The trend in each country can be hardly figured out in 1970s, as this is a period of fluctuations. It seems, however, certain that Korea,

Table2 — 6 Investment efficiency of selected contries since the 1970s

	Investment ratio				GDP growth rate			ICOR		
	1970	1980	1990	1999	1970-80	1980-90	1990-99	1970-80	1980-90	1990-99
Korea, Rep	25	32	38	27	9.6	9.4	5.7	3.0	3.7	5.7
Singapore	39	46	37	33	8.3	6.7	8.0	5.1	6.2	4.4
Thailand	26	29	41	21	7.1	7.6	4.7	3.9	4.6	6.6
Indonesia	16	24	31	14	7.2	5.8	6.1	2.8	4.7	3.7
Nepal	6	18	18	19	…	4.6	4.8	…	3.9	3.9
India	17	21	25	24	3.4	5.8	6.1	5.6	4.0	4.0

Remarks: ICOR: Incremental Capital Output Ratio
ICOR(1970-80) = [Investment ratio(1970-80)]/[Growth rate(1970-80)]
Investment ratio(1970-80)= average of the two ratios

Source: the same as Table 2-4.

Singapore, Thailand and Indonesia had seen deterioration in their investment ratios amid the experience of a high growth.

Now, in interpreting ICOR in Table 2 — 6, there is a point to be duly considered. This means attention to the trend of world markets and natural conditions. Showing here detailed statistics has to be omitted. But, it is undeniable that the large-scale strife in a neighboring country or the international trade liberalization thereafter favorably influenced the so-called high economic growth experienced by the Japanese economy after the Second World War. Also, it can not be ignored that the high economic growth of Japan and economic policies of the Reagan Administration of America exerted a great, positive influence on Korea, Taiwan and the Southeast Asian countries, becoming important factors to shape a new economic integration in the western pacific region. It will happen that such an external element unexpectedly helps raise investment efficiency. There is no need to explain in detail that the state of natural conditions will eventually have a great influence on investment efficiency. In any case, it is the fact that those countries mentioned in Table 2 — 6 could experience an improvement in investment efficiency as an eventual result from the external factors together with their self-help efforts (the realization of high investment efficiency and the promotion of technological progress). It is hoped that the fact should not be forgotten.

Considering the experience of major countries of Asia and the current situation that does not warrant an optimistic hope for a rapid economic expansion, a long-term (average) level of ICOR that can be kept in mind by Laos is possibly 4-5 or around 6 depending on circumstances.

The domestic investment ratio of Laos in and around 1999 is estimated at 24%, according to the above-mentioned same report of the World Bank. This level of 24% of investment ratio nearly corresponds to figures of Korea in 1970, Thailand in 1970 and Indonesia in 1980. As repeatedly pointed out, these three countries achieved an amazing economic growth and that their ICOR were 3-4 and 7 respectively. It is unthinkable that Laos is capable of continuing an average of these ICOR levels for 10-20 years in the future because the country should devote itself for infrastructure construction including roads and telecommunication sectors. Thus, it is obvious that the country should be ready for managing the economy under lower investment efficiency. Suppose ICOR is set at a lower level and then a plan intended for a large-scale investment is formulated and implemented, managing the economy in Laos will become extremely severe even from a long-term viewpoint. This will be discussed also in the final report of the study project in detail and multilaterally.

3ÅjInvestment efficiency of the Lao economy

The investment efficiency (ICOR) of Laos will be four at the most in the future and possibly 6 in lower cases, according to the preceding discussions. Then, the question is that practically what degree of ICOR the Lao economy has been realizing since the latter half of 1980s when the economic liberalization and opening to western countries became full-fledged. In order to draw out in the plan the Lao economy twenty years hence, it is necessary to examine the past of the same duration or a longer time span. It is, however, really disappointing that the macroeconomic statistic of Laos lacks a decisive point despite the lapse of a long time of 15 years after the liberalization in 1986. When a target growth rate is set, questions will arise, namely, how much investment will be needed, to what extent a resource balance (a gap between investment and savings) will occur and what sort of economic influence will happen. In working out a clear perspective for those points, it is important how perfectly national income statistics have been prepared.

As mentioned previously, the discussion on investment efficiency here makes use of a very simple mode and data of approximation (not capital stock data but directly using domestic crude investment data). Figures concerning investment at macroeconomic level are not available, like the case of data on savings. Inevitably drawing an overall picture of the Lao economy or mapping out a rough perspective has to be a work of conception (in other words, a stretch of imagination).

Nevertheless, though limited, there are valuable work results or studies and researches leaving useful various hints [1]. The simple calculation results are of nature that these should be modified with steady statistical collections, processing and analyses in the nearest future possible. However, presumably it will serve here at least as a reply to the presentation of long-term issues for the Lao economy. (Table 2Å|7)

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[1] For example, Maxwell J. Fry, Saving, investment and economic growth in Laos, in Laos' Dilemmas and Options – The Challenge of Economic Transition in the 1990s, edited by Mya Than and Joseph L.H. Tan, Institute of Southeast Asian Studies, Singapore 1998, or National Economic Research Institute, Lao Economy at Crossroads, State Planning Committee, Lao PDR, 2000. In addition, there are the results from individual calculation works by many study teams that were dispatched from the World Bank, IMF and many other international aid agencies to visit Laos at the end of 1980s on.

Table 2 − 7 Investment and Saving in Laos

(% of GDP)

	Domestic Investment	Domestic Saving
1984	8.8	5.2
1985	9.4	3.7
1986	4.1	6.0
1987	13.7	5.8
1988	18.0	4.0
1989	18.6	3.0
1990	13.3	2.8
1991	15.4	3.9
1992	13.4	13.3
1993	16.6	10.2
1994	17.2	11.4
1995	24.5	11.5
1996	29.0	12.4
1997	26.2	9.9
1998	28.6	18.1
1999	36.4	11.6

Remark: As for 1984-1992, Fry (1998). See the footnote of page 13.
As for 1993-1999, National Economic Research Institute.

According to Table 2 − 7, from 1984 to 1992, the average investment ratio is 12.7%, the average growth rate 4.2% and ICOR 2.9%. And, from 1993 to 1999, these are 25.5%, 6.5% and 3.9% respectively. The 4.2% growth rate was secured in the first half of the economic liberalization owing to highly efficient investment. It can be seen, however, that as a result of positively raising an investment ratio during the last half, the efficiency index deteriorated considerably in a short period of time though the growth rate rose by 2.3%.

The following will be mentioned again at the end of this chapter, but there is the fact that various conditions (economic self-sufficiency, non-monetary economy, self-sustaining agriculture and inland mountainous nation) are still involved in the Lao economy. Overcoming these conditions, thereby establishing efficient financial and labor markets for improving the present investment efficiency will take a considerable time. Thus, inevitably a positive investment in a short period of time will cause unfavorable influence on the entire economy.

As the next chapter will mention, many point out that the cause for the confusion of the Lao economy at the end of 1990s is the Asian monetary and economic crises. Also, the influence due to domestic factors, for instance, the macroeconomic effect caused by a large-scale investment such as investment in irrigation should not be ignored.

In short, speaking in advance of a bit of conclusion, even if a foreign aid is available, there is a limit in the absorbing capacity of capital in a sense of raising the overall growth rate by utilizing it. In the case of Laos, perhaps it will be around 25% at the very most. And, even at a greater figure, it will not be combined with ample fruit. Rather, it may cause inflation or a fall in exchange, possibly resulting in losing an important step towards economic development.

2 — 2 — 2 Resource balance and investment efficiency

Once again let us see the movement of investment rate and saving rate in Laos by checking Table 2 — 7. The gap of both rates, namely, I-S balance has repeated expansion and shrinkage since 1984, but we can see clearly that the absolute figure has become large on a long-term basis. In addition, Figure 2 — 3 shows clearly that the I-S balance in Laos has

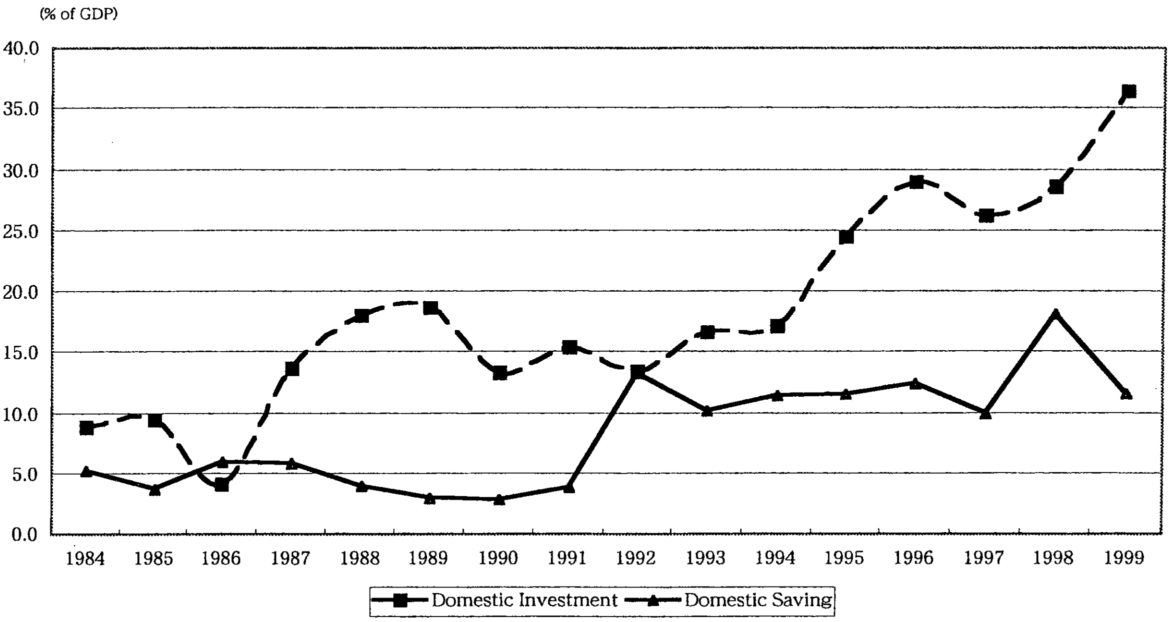


Figure 2 — 3 Resource Balance of Lao PDR

Source : The same as Table 2 — 7

worsened recently due to sharp expansion of investment rate. In this situation it may be appropriate for us to think that the I-S balance is actually larger because "saving" in this statistics is gross saving without consideration of depreciation.

2－3 Policy Implications for Sustainable Development

2－3－1 Review of the Government Plan

It is desired that examining policies on a long-term economic development of Laos should be made based upon the above discussions. Table 2－8 shows contents summarized from the recently released English version of "Socio-Economic Development Strategy For 2020, 2010" and "Five Years Socio-Economic Plan (2001-2005)".

Table 2－8 shows that the Laos government has set its targeted growth rate at about 7 % during 2000 to 2010 and 2010 to 2020. When we see the Lao economy of the past 20 years by five years, first of all, they have never achieved as much as a 7 % growth rate. The annual average growth rate which they realized is 5.5 % during 1981-1985, 4.5 % during 1986-1990, 6.2 % during 1991-1995 and 6.2 % during 1996-2000. It appears that they have achieved higher growth rate than that of their neighboring countries by realizing technological development of each sector under economic and liberalized measures, and by effects of improvement in efficiency of shifting production elements among each sector. If we pay attention to the past 20 years of experiences, growing fiscal budget deficit and inflation which have become evident in 1990s, however, it is not an easy task for Laos to continue to expand economy for the next 20 years only by depending on quantitative increase of investment even if the nation is still in developing conditions. For example, construction of infrastructure may be necessary to expand supply capacity of the total economy and such large-scaled and sudden public investment may stimulate much demand but if they do not have enough supply capacity beforehand which meet such demand, short-term excessive demand is considered to cause inflation and have bad effects on important factors (desire and realization of new investment by farmers who are engaged in food production and by producers who make traditional goods, and poor performance of resource export-oriented industries by unfavorable trade terms) which decides long-term supply capacity.

When we consider the growth rate, which the Lao economy has experienced so far, such average growth rate per year as the above during each ten long years is a very ambitious goal. They need about 25 % of investment rate in order to realize this targeted growth rate

Table 2 — 8 Development objective for next 20 years of Lao government

	1986-90	1991-95	1996-2000	2001-05	2001-10	2011-20
population at the end of period (million)	4.1	4.6	5.1	5.9	6.7	8.3
Percapita GDP at the end of period (US$)	210	350	350	500-550	700-750	1200-1500
annual GDP growth rate (%)	5.0	6.4	6.2	7-7.5	7.0	7.0
growth rate of :						
agriculture	3.4	4.1	4.5	4-5	…	…
industry	7.7	12.3	10.8	10-11	…	…
service	7.1	6.7	7.8	8-9	…	…
GDP share of:						
agriculture	61	52	52	47	…	…
industry	14	21	22	26	…	…
service	24	25	25	27	…	…
import duty	1	2	1	0	…	…

Source: Socio-Economic Development Strategy For 2020, 2010 and Five Years Sosio-Economic Plan (2001-2005), State Planning Committee, Government of Lao PDR.

and ICOR should be about 3.6 if the plan is carried out as scheduled. If we take into account the past experiences of Laos and other countries, they have comparatively high investment efficiency in mind.

As mentioned earlier, when we take the development stages of Laos into account, we can safely say that ICOR will move to a level of four at best, or at five or six depending on the particular year during the next ten years. This is because the demand for the construction of infrastructure will continue to expand in Laos for the next ten years in spite of the considerable period of globalization and foreign aids of main developed countries since the economic reform, and it is fully expected that total investment efficiency will stay at comparatively low level by putting priority to making investment in these fields in advance. It is difficult for us to suppose that they can achieve rapid improvement in productivity for a short period of time in the process of introduction and spread of new technology to the country. Judging from the above, we should estimate that investment efficiency would be four or five at best at least for the next ten year from now.

If, however, we presume that ICOR will be four or five, they must achieve investment rate of macro-economy at 28% to 35% against the targeted growth rate of 7 %. We must be cautious of the fact that such level is the one of the investment rate, which was achieved by Asian countries during the significantly high growth period, which was called the bubble economy by some countries, before the currency crisis. These countries, which have experienced rapid industrialization, are not necessarily highly evaluated but it is true that they have achieved a certain development in the domestic financial market. If the size of productive activities becomes large as the economy develops, an efficient capital accumulation mechanism will be required accordingly. It is not an easy task for us to hike macroeconomic investment rate for a short period of time and keep it at a level as the economy grows. It is not something, which can be achieved only by the initiative of the Government.

2－3－2　Saving mobilization

We showed that the targeted annual growth rate of 7% would be realized if investment ratio would keep the level of 25-30% assuming that ICOR is four thorough the period. This scenario is ambitious one also in the meaning that required domestic saving ratio would be high even if foreign aid would be available to some extent.

Further we should note the point that the domestic saving ratio referred in the Government plan, which is estimated around 12% for the period from 1993 through 1999, does not necessarily contain the capital depreciation. It is critical to recognize that the required saving ratio in the plan is the underestimated, and that much more effort in saving mobilization should be made comparing to the scenario of the Government plan.

According to the outcome of "the Country Study for Japan's Official Development Assistance to the Socialist Republic of Viet Nam (JICA 1995)", the depreciation ratio as percent of GDP of Viet Nam was estimated around 7% for the year of 1989. The study report says that it is important for low-income countries like Viet Nam to think of domestic saving not in terms of "gross," but in terms of "net" saving from which depreciation charges have been subtracted. Considering the estimated value of depreciation ratio for the Viet Nam, we have to say that the saving ratio of Laos could be far less than the needed level.

As is discussed in other sections, the Government should play positive roles so that they may mobilize domestic savings and use them for efficient productive activities. But it is doubtful if the Government saving, or the revenue (tax collection) on the part of the Government sector and expenditure of the Government are functionally controlled as a whole. These problems have already been pointed out by such international organizations as the World Bank and IMF, but more detailed surveys in our survey project will reveal that the high growth policy and the positive policy on introduction of foreign aids of the Government may make financial management more difficult and help induce financial instability, coupled with the cost burden problems of operation and maintenance and recent decentralization. In this chapter, we would like to point out that it is important for the Government itself to mobilize savings at the moment under the stable financial conditions so that they may grow and develop their economy in future. The problem will be discussed in detail in the next chapter on Fiscal Management.

2－3－3 Basic View on External Debt Management

The problems here can be classified into three: ① most of the investment funds in Laos come from foreign aids not from mobilization of domestic saving ② insufficient investment efficiency sometimes does not produce new income by investment from aids ③ if even part of new income, small it may be, is not absorbed as saving, the domestic I-S balance will worsen, international balance or current account in the red ink appears and as a result international debts will increase.

But the problems ① and ③ are deeply related. And so it is important for them to absorb income securely as domestic saving by improving investment efficiency to the full and producing as much as income by small investment so that they may develop economy on a long term basis. We would like to make concrete proposals. It is truly important for them to build infrastructure within a range of not inducing sudden inflation, introduce new technology, foster human resources, form efficient systems and organizations, and improve and maintain banking sectors as a means of strengthening organs of money channeling in order to absorb saving fully. But what is more vital a problem is not to spur inflation on a long term basis or in other words to stabilize their own currency and check the occurrence of purchasing power gap between their currency and foreign currencies now in circulation by promoting small and medium-sized investment and production activities both in agriculture and manufacturing industries.

2－3－4 "Stop-And-Go Policy" in the high growth period of Japanese economy: Its Possible Relevance to Laos of Today

Since the latter half of 1950s through the early 1970s, Japanese economy had been facing the constraint of balance of payment because of the rapid expansion of domestic investment.

Actually Japan was employing the fixed foreign exchange system at that time. It was the main reason for the balance of payment problem. However, from a long-term viewpoint, to peg the foreign exchange rate was an effective strategy for Japanese economy to enjoy the enormous benefit from international trade because of increasing competitiveness of exporting industries.

Whenever the Government recognized the deficit of balance of payment, the central bank tightened up the money supply and succeeded in bring down the heat of economic activities domestically, and in lifting up the ceiling of balance of payments by decreasing import in short run. At the same time they were waiting for further increase in international competitiveness in the exporting industries. It was another factor of importance that enabled the economy lift up the ceiling in medium and long run. By the way we can say that such monetary policy was successful partially because the fiscal balance was kept due to the actual revenue increase backed up by high economic growth. Actually Japanese government did not issue the public bond in this period.

The past experience of Japan mentioned above seems to be informative for today's Lao economy. In case of Laos where the policy options for macro economic stability is quite limited, keeping the parity of national currency is very important to incubate the business idea of domestic entrepreneurs and farmers. It is also said that to keep the value of national currency would be one of the fundamental conditions for financial deepening in long run.

However we do not say that the Government should take the fixed exchange rate system immediately. Our point is that relatively strict management of balance of payment is important. It would be possible to certain extent by monitoring some of macroeconomic indicators in simple ways, and by reflecting the result in the short-term policy formulation.

In Laos, foreign exchange rate is monitored precisely to some extent by the central bank. It can be employed it as one proxy to judge whether the pressure of account balance would be increased or not. Here we should pay attention again to fiscal management in the meaning that strict public expenditure control based on the movement of foreign exchange rate might be effective for stabilizing the macro economy.

In case of Lao economy, where domestic resource mobilization was not successful in the past, public investment assisted by foreign aid has been playing an important role in socioeconomic development. However, in some cases, rapid expansion of public expenditure will be of negative impact on the macro economic situation as discussed in the preceding sections. Attention should be paid to the point that public expenditure will directly increase the import for goods and services mainly because of the limited capacity of Lao economy.

For the time being, it is critical whether the Government could keep the Kip value through controlling the public expenditure and the balance of payments.

Nevertheless the consolidated budget system of the Government is not so operational for appropriate monitoring. For instance the amount of the so-called counterpart fund as well as of the operation and maintenance cost is not clear even in the annual budget document especially for the provincial governments despite the fact that it is crucial issue for Lao economy from the long-term viewpoint. In this context the Government should consider to reorganize the budget system comprehensively so as to manage the budget on a strict and transparent "rule" from a long-term viewpoint.

First step is to grasp precisely the magnitude of demand for the local fund to receive the foreign aid projects and programs both at central level and provincial level, and demand for capital expenditures by the provincial governments. Further the so-called operation and maintenance cost financing should be totally monitored precisely by the central government.

Second step, which would be relatively drastic for the Lao government, is to take "Balanced-Finance Principle." It is to balance the sum of capital expenditure and current expenditure with the sum of tax revenue and foreign aid. In other words it means to close the way to issue the Government bonds. In Indonesia the Government had been taking this "Balanced-Finance Principle" since 1966 until the recent years. In Laos, current situation, where the demand for current expenditure at national level is not monitored accurately, might be the background of the fiscal deficit under the pressure of investment expansion by the Government as a whole. Therefore the introduction of this kind of budget system should be considered to improve the accountability of the Government to the international aid community.

3. Fiscal Management

Bounsamack Xayaseng

In the previous chapter we discussed basic problems on macroeconomic management focusing on the problem of I-S balance. The important point for discussion here related to fiscal management is whether or not they can raise necessary fund by mobilizing domestic saving focusing on reducing dependence on foreign aids when they intend to achieve comparatively high growth rate on a medium and long term basis.

First of all, the problem is how to raise fund if Laos joins AFTA because there is a fear that their revenues will decrease remarkably during 2003-2007 when almost all items for export are liberalized. Secondly, it is a problem of expenditures. They have to make effective use of foreign aids at the moment even if they intend to decrease dependence on their aids on a long-term basis. The problem which has been traditionally pointed out on this matter is how to secure the budget by which they operate and manage the projects. If the Government-led projects increase every year together with positive introduction of foreign aids, recipient's fund-raising in their portion for foreign aids in particular and fund-raising for operation and maintenance fees of the investment projects which were made several years ago as aid projects do not agree in budget and as a result investment efficiency in the projects may worsen. And thirdly, it is a problem of recent "decentralization" which may have bad effects on these two problems.

3－1　Current Policy Issues: Five-Year Financial Policy (2001-2005)

Under the new overall renovation policy, endorsed by the VIIth Congress of the Lao Revolutionary Party, the Lao party and Government have paid attention to improvement of financial policy to make it in line with the pace of socio-economic expansion. This aims to mobilize and explore more domestic revenue sources following the notion of self-reliance, self-sufficiency and self-strengthening, to manage expenditures effectively, to economize according to the policy of the party, and to improve measures to proportionally balance the budget based mainly on domestic sources. In addition, the policy also aims to ensure distribution and effective use of funds from the budget, manage the use of foreign aid-loan according to the policy, build financial stability and make financial system more strong and transparent.

3－1－1 Actual Situation of the Implementation of the Financial Policy over the Past Years

It is evidenced over the years that Gross Domestic Product (GDP) and budget revenue are closely interrelated. If GDP increases, budget revenue will also increase.

Nevertheless, inflation and foreign exchange have affected to a certain extent the mobilization ratio from GDP into the state budget. In a time when economy expands, tax revenues will also increase. However, if inflation increases and foreign exchange rate moves dramatically, real income of taxpayers will decrease. Consequently, it will affect state revenues directly.

After our country has entered the implementation of the renovation policy and gradually adjusted to market economy, by acknowledging its importance, the Government has attentively re-established the linkage between financial-monetary system and social economic development. This has created basic stability and continuos development based on hidden potentials of the country and has also attracted assistance and cooperation from other international friendship countries in the world. Focus has been paid on fruitful implementation of eight priority programmes step by step. Attention has been on amendment of financial and budget regimes, rules and regulations to promote production, alleviate people's poverty, empower local to use own resources and capacity to create revenues and to serve the development projects on the spot. This moves towards enabling all locals to become self-sufficient and balance their own budget by themselves and fulfil their obligation to the central government. The details are as follows:

(1) Improvement of Budget-Financial System and Financial Policies in Each Period

1) Revenue Sources Exploration

- Some Chapters of the Tax and Customs Law have been amended to make them in line with socio-economic situation conditions in each period. These include import tariff, land tax, some types of tax rates, amendment of leasing rates for public assets, and foreign exchange rate in order to calculate tax and customs and other fees according to the actual situation.
- Special attention has been paid to improvement of steps of calculation, collection and presentation of tax revenues to make it more brief, simple and transparent, especially when fulfilling an obligation to contribute to the budget, taxpayers pay directly by themselves to the National Treasury.

- In order to implement the party and government's land policy, which aims at making effective land management and development one of the main revenue sources of the budget in the future, the Government has attentively pushed land measuring and titling projects. This is to enable people from all ethnic groups to get the right to use and inherit lands as stipulated in the law. The new decree on land tax, effective in August 2000, has become a new landmark in promoting land use and development according to the direction in promoting farmers to produce more goods for sale.
- Overall, the tax and customs system over the past years has been correctly applied according to the role based on market economy mechanism. The development of an open oriented economic sector has been encouraged and business and service sectors have been expanded in order to adjust and redistribute income and explore more and more revenue sources. From here, tax and custom revenue has become the main revenue source of the state budget and continuously increases. For example, in the year 1999-2000, tax and custom revenue covered 80% of all the revenues comparing with only 64.2% in the year 1995-1996.
- At present, we are implementing the Decree No. 192/PM and Instruction No. 01/PM of the Prime Minister on building up provinces as strategic units, districts as planning and budgeting units and villages as implementing units. This policy actually promotes financial responsibilities of the provinces, districts and village authorities. The implementation of this policy is becoming a lively process in various provinces. Until now, village finance has basically been established all over the country resulting in various changes. Each village has started to grasp their own socio-economic situation and make initial planning. At the district and provincial levels, responsibilities have been increased especially in revenue collection and mobilizing grassroots potentials in local socio-economic development to make it better step by step.

2) Expenditure Management

- Over the past, main expenditures were focused on ensuring payment of salaries, normal administrative expenditures, national defense, building rural development grassroots, investment in essential infrastructure, especially in food production promotion projects, agricultural production of goods, contributions of fund to grant and loan projects and foreign debt repayment.

- Attention has been paid to monitoring of the implementation of the Prime Minister's Instruction on economy. Expenditure audit has been encouraged to ensure that budget expenditures are made according to the law. The rules on administrative expenditures and economizing on fuel, phone, and water have been set up. The policy No. 194/PM has been implemented to reduce state subsidies.
- Attention has been paid to strictly enforce financial regulations on breaking expenditure plan and setting up treasury specifically not in accordance to the law.
- Attention has been paid to monitoring the implementation of steps in infrastructure investments from the time of project formulation, evaluation, to completion and conclusion of results of the infrastructure building.
- State Planning Committee has been closely cooperated in doing budget revision, distribution, allocation and implementation of the annual socio-economic development plan based on the repayment capability of the budget so that budget can be used according to the Government focus point and in accordance with the reality. In the year 1999-2000, 64% of total expenditures were focused on development investment comparing to only 54% in the year 1995-1996.

3) Mobilizing Revenue Sources for the Budget Balancing

- Budget deficit has gradually been reduced. For example, in the year 1999-2000, budget deficit remained at 9%, 3% reduction comparing to the year 1995-1996. This is due to an increase in exploring new revenue sources, limit unnecessary expenditures, use of intended budget subsidies through different domestic loan modalities, such as selling of government bonds and bank securities through the bidding of interest rate. Since the fiscal year 1999-2000, based on self-reliance notion, we have decided to implement measures not to advance from banks (this is a temporarily measure using only during the period of financial-economic instability). In addition, we must also mobilize and use foreign aids and loans more effectively.
- Mobilizing funds from domestic sources in the form of government bonds and long term government securities with reasonable interest rate is suitable in this period and is an important balancing source which government and party use in subsidizing budget deficit to meet development investment target.

4) Financial Policy for Development Investment

- Various policies in the Foreign Investment Promotion and Administration Law, Domestic Investment Promotion Law, and Tax and Customs Law have been adapted. This is to make them more suitable to economic expansion situation in each period and to boost and promote expansion of business production and investment, enabling participation of all economic sectors in socio-economic development investment.

The implementation of right foreign policy by the Government and party over the years has broadened economic cooperation with foreign countries and international financial institutions, enabling opportunities to boost sources to provide funds to various projects averaging at US$ 150 million annually. This amount is from loans between governments, loans from international financial institutions with low interest rate and long-term capital-interest repayment. In addition, grants from friendship countries and international organizations have also been reasonably boosted.

- Domestic capital supply has been ensured to contribute to certain extent to foreign aid-loan projects. Special attention has been paid to ongoing projects to ensure completion of the targets and be able to put into effective use on time.
- Investment in agricultural expansion and goods production has been attentively increased from domestic capital as well as from grants and loans. At the same time, irrigation projects have been transferred to farmers to manage and to recover capital by themselves as to make it a village source of fund for maintenance of the irrigation as well as increase production of goods.

(3) Evaluation of Implementation of Financial Policies Over The Past Years

1) Strong Foundation of the Financial Policy are seen as follows:

- Normal expenditures have been ensured. In 1999-2000, savings increased 3.7% comparing to GDD and reserves accumulated. Budget expenditures have contributed to development investments in accordance with the policies. The focus has been on sufficient and extra food production, investment in expansion of agricultural production of goods and building up rural development infrastructure.

- The Prime Minister's Decree No. 192/PM on the implementation of the State Budget has been implemented to decentralize budget management and divide responsibilities to provinces in revenue collections and control of budget expenditure based on assurance of centralized budget rules. This aims at building up provinces as strategic units, district as planning and budgeting units and villages as implementing units.

2) Shortcomings in the Implementation of Financial Management Over the Past Years

An analysis of data figures has pointed to the following limitations and shortcomings of the implementation of the financial plan and policy, which need to be addressed to make it in line with the needs and macro-management role:

- There is no strong foundation for the formulation of annual budget plan especially revenue promotion plan and lack of capability to forecast any contingency situation that may occur. Thus, in practice budget implementation is faced with difficulties and uncertainties. Domestic borrowing plan by issuing government bonds cannot be implemented according to the plan. The cause of this delay is due to unclear domestic borrowing policy, inflexible and unreasonable interest rate not in accordance to each period. Foreign borrowing is full with strict conditions. But in effect, they have not been well applied. Many difficult and complicated steps have not been modified.
- Existing tax and customs policy tends to be on solving immediate problems. It has not yet become an effective macro-management adjustment tool. Specifically, it has not promoted business production and domestic savings and has not mobilized capital sources for development into truly established revenue sources in the future.
- Monitoring and management of budget revenue has not been really well implemented, resulting in loss of some revenues, gaps, injustice, and inequality in front of the law. On the other side, revenue policies have not been adjusted to the real situation. Therefore, they have not become effective tools in promotion of production. This has created gaps which cause revenue losses.
- The lack of capable staff to work in various levels of the financial sector engine, especially in provincial level plus the lack of strong political will of some financial officials has resulted in inability to correct discouragement incident occurred in budget-financial sector on time. This has also restricted the fruitfulness of budget

management.

3－1－2　The Five Year Financial Policy (2000/2001-2004/2005)

(1) Overall financial policy

- Ensure financial and monetary stability by controlling inflation rate under expected level in a normal range and not more than economic progress rate. Maintain stability of the value of Kip and exchange rate to ensure continuous socio-economic expansion. Continue building up economic structures of agriculture-forestry, handicraft, industry, and services to transform according to objectives of the Five Year Socio-Economic Development Plan. Create conditions facilitating cooperation and effectively attracting foreign development investment at the same time.
- Improve financial policy and create enabling environment for the expansion of market economy. Strongly boost production of goods as a foundation for expansion of labor, goods and financial markets. Improve financial and credit regulations to enable operation of small and medium sized businesses to expand and to be comfortably and correctly conducted.
- Encourage and explore all revenue sources to ensure normal national expenditures. Increase investments while maintaining some reserves. Distribute and reasonably use budget sources in a way that it promotes expansion of production, especially agricultural business production, rural development, and relieve of people's poverty. Manage revenues in foreign currencies centrally and strictly, ensuring strong state foreign exchange reserves. Strictly implement economical national policy in every region in order to eliminate unnecessary financial and monetary subsidies step by step and to ensure reduction of budget deficits according to the target.
- Attentively mobilize domestic capital sources by using various financial and monetary tools that are effective in many aspects. Increasingly create new revenue sources. Build up essential conditions step by step for establishment of capital market, which is a source of long-term capital supply and investment accumulation in a long-term.
- Promote micro finance projects in order to provide opportunities for people to be able to use capital in their business production.
- Gradually develop and improve modern financial technology and communication to move closer to international practice and to coordinate with neighboring countries'

and ASEAN networks.

・Provide capacity building for financial officials to be able to manage budget finance in the new period. There is a close correlation between the number and the quality. Here special attention will be paid to upgrading knowledge and increasing numbers of trained officials at the provincial and district levels.

(2) Sectoral Financial Policy

Improve financial policy and create enabling environment for the expansion of market economy. Strongly promote production of goods as a foundation for the expansion of labor, goods and financial markets. Improve financial and credit regulations to enable operation of small and medium businesses to expand and to be conducted in a comfortable and correct manner.

1) Revenue Policy

・Consider the use of Value Added Tax (VAT) instead of the turnover tax which has a narrow tax band and set up regulations and various restrictions to be a base for this implementation.

・Improve revenue collection management to increase more revenues. This is linked to the policy of division of responsibilities between sectoral ministry and local.

・Reconsider managing state own enterprises and firms in which state has a share by organizing them according to size of capital, income creation, and profits. Closely monitor and control with various rule and regulations and consequently move toward hiring managers of state owned enterprises to manage and maximize benefits of state capital in state owned enterprises and firms in which state holds a share.

・Attentively promote private small and medium sized enterprises (SME) in many ways to enable smooth operation for those businesses, which are successors in producing high value added products. Enable export capability and import substitution and prepare for accession to AFTA of the Lao PDR by:

— Building up specific bank to provide capital with low interests and mobilizing grant aids of the Japanese government to be used as promotion capital.

— Considering imposing specific restrictions to determine clearly and in details on small and medium businesses and which vocational sector to be promoted or not.

— Providing marketing information and assistance in domestic and international market research.

— Providing sample of needs and popular use of products and foreign products to promote export production.

— Assisting and creating conditions for business people to receive training from relevant sectors according to their vocational background and providing opportunities for them to participate and exchange experiences and to attend domestic and overseas excursions.

— Imposing low tax and customs in order to promote smooth operation of SME.

2) Expenditure Policy

- Effectively manage state budget expenditures. Turn a part of administrative expenditures, which is a personal benefit, into salary structure. Consider tendering of salaries. Set up various restrictions on budget expenditures to create a place where planning for budget expenditure can completely and clearly base on.
- Turn expenditure management investment by setting up Trust Funds, which will be able to provide capital with low interest to large state projects by giving the Trust Fund the role to organize bidding, monitoring and evaluation of state investment projects. Sources of funds of Trust Funds are:

  — Insurance money from insurance companies

  — Funds from social insurance organization

  — Funds from postal savings institutions

  — And other sources.
- Selling of long-term Government Bonds with low interest rates to people to attract capital in the society.
- Consider setting up secondary capital market to facilitate selling and exchanging of government bonds, securities issued by banks to the people and to be a foundation for the creation of capital market in the future.
- Promote capital contribution of people to village development funds (at the beginning it was called village development bank as it was limited in size and quantity). Mobilize this funds to become credit sources with low interest rate, providing essential capital to people in the village to plant, raise animals, trade, and make handicraft products for sell in markets.
- Together with promotion of people's contribution to the village development fund,

the Government provides technical support to local. Different villages organize production groups, processing, and buying-reselling groups. Each village will choose one of activities that creates income for the village according to its own potentials and direction of "one village one product".

(3) Targets of Financial Macro-Economy for the Five Year State Budget Plan (2001-2005)

In five years time, financial plan and financial policy must ensure the achievements of the targeted macro figures as follows:

- Intensify revenue collection with a pace faster than a need for normal administrative expenditures to support the task of administration and management of the state and to gradually increase savings. Therefore, between the year 2000-2005, revenue collection must strive to increase between 14%-18% of GDP (average annual increase of 1-1.5%) and especially in the year 2004/2005, the increase must not be less than 18% of GDP.
- Strive to achieve budget deficit reduction from 0.5% to 1% annually so that budget deficit average in the year 2005 will be at the level of 5-6% comparing to GDP, which is a rate that developing least developed countries have adopted.
- Strive to meet plan to increase state saving ratio compared to GDP from 4% in the year 2000/2001 to 6-7% in the year 2004-2005, an average annual increase of 0.5-1%, to enable state domestic investment to reach 6-7% at the end of this five year budget plan. This means that we must attract external sources of about 5-6% of GDP. Total state budget will be at a level of 12% of the GDP.
- Settle prolonged debt, especially debt incurred between budget and bank, prolonged debt between budget and firms and treasury debt.
- Ensure that expenditure structure is in proportion with the directions of salary payment assurance, beneficial policies for officials, solders and police, normal administrative and maintenance of public property expenditures, expenditures for national defense, security, and socio-cultural activities and supply for reasonable public investment. Therefore, from now until 2005 expenditure management will take up 50% of the total expenditure structure while investment expenditures will cover 50%.

3－1－3　Measures for Implementation

(1) Long Term Basic Measures

- Organize reasonable investment structure in each sector, region and every economic sector to increase investment effectiveness, enhance production efficiency, quality and effectiveness, build competitive capacity of Lao products in domestic, regional, and world markets.
- Make financial policies that are in line with production promotion and protection, linked with poverty alleviation of the people and promote social equality in all aspects.
- Make reasonable expenditure policies (including production and private expenditures): ensure production promotion and make it in line with economic capability in each period. Strictly economize expenditures to increase saving.
- Continue to enhance foreign relations and international economic cooperation to integrate with other countries and to compete for funds, technology and administrative experience, based mainly on the notion of self-reliance, self-support and self-strengthening, aiming to limit risks and achieving real goals.
- Develop information system, apply modern technology to ensure budget revenues and create transparency in financial sector to determine policy direction and financial plan that are in line with actual situation in each period.

(2) Immediate Measures

1) Mobilize revenues from domestic sources by:

- Reviewing tax and customs and other laws, including all the policies and regulations related to budget revenue collection in order to adjust any incompatibility and add the ones that are still missing to propose to high level for approval. These include substitution of value added tax (VAT) to the turnover tax which is expected to be effective from 2003. Aim at ensuring public expenditures as well as export production promotion of all economic sectors.
- Monitoring the implementation of tax and customs policies, domestic and foreign investment promotion policies, especially the policy to impose import tariff of 1% of the import value of production machinery and various equipment used for investment purposes, as the implementation of this policy has considerably created losses to public benefits.

- Continue improving the management of revenue collection from large taxpayers and turn this management responsibility to major provinces as well.
- Strictly manage all revenue sources, collect revenue on time, implement revenue tendering, reasonably divide level of expenditure management to local level.
- Assign responsibility to districts and villages to collect certain line of revenue. This is compatible with the policy of building up provinces as strategic units, districts as planning and budgeting units and villages as implementing units, as stipulated in the Decree No. 192/PM, from which instructions and regulations have clearly been issued.
- Apply flexible exchange rate in each period in the calculation of various tax and customs because as exchange rate moves, budget revenue will also move like a shadow.
- Centralize revenues in foreign currencies, especially revenues from selling of timber, electricity, airspace charges and etc. in government reserves to meet the need of public expenditures in foreign currencies.

2) Division of annual budget expenditure must abide by the rules:

- Every revenue and expenditure line must be reasonably reflected in the budget plan according to the direction to focus on projects that have a focus point and are effective. End unplanned expenditure situation, especially administrative expenditure and infrastructure investment outside the plan.
- Organize structure and ratio of infrastructure investment compatibly, issue instruction on management of infrastructure investment, restrict and decisively end credit borrowings to invest in building infrastructure.
- Plan to settle most of prolonged debt in five years time, beginning with non-payable debt in the Treasury, debts between budget, and bank, and debt between budget and enterprises.

3) Manage the budget according to the plan endorsed by the National Assembly:

If revenue cannot be implemented according to the plan, the plan must be adjusted by rearranging according to the direction of expenditure reduction; unplanned expenditures or expenditures over the plan are not allowed, except in a special case which has to be approved by the Government only.

4) Implement measures to economize expenditure by considering moving some administrative expenditures that are related to officials to salary payments, including

electricity, water, fuel, phone charges...in order to reduce and consequently eliminate subsidies in state budget implementation.

5) Enhance expenditure audits in various sectors and locals to ensure that financial rules are followed and expenditures are made according to the target and to ensure effectiveness. Correctly implement accounting and financial reporting system correctly according to the rules and time limit in various ministries, sectors, locals and grassroots.

6) Improve financial sector organization from central to local level to enforce political mentality, strengthen organization, gain professional capability and have work plan, impose strict regulations in order to satisfy every sector's needs in increased national financial development and international and regional cooperation. Enhance adjustments of organizational machinery of the inspection department of the Ministry of Finance. Impose restrictions and regulations on financial-banking audit, provide capable staff with right qualifications to that organization. At the same time, promote normal activities and exchange experiences in each period.

7) Link administrative expenditures of various sectors with professional revenue that the sectors organize to collect. State budget will provide for the difference between revenue plan and expenditures of that sector.

Plan and complete the building of financial collage at the end of year 2005 to create human resources in financial sector to meet the number needed in all over the country. At the same time, build up financial institution by choosing financial personnel and inviting others who used to work in the Ministry of Finance and are capable, knowledgeable, experienced and accepted by professionals to join. Apply for capital and technical assistance from foreign countries in order to conduct a research on financial policy strategy and to enhance staff's financial technical level.

3 − 2 Analysis and Discussion: Fiscal Revenue

3 − 2 − 1 Possible Impact of AFTA on Tax Revenue

Figure 3 − 1 shows relation between income level/person and revenue structure of the Government. The horizontal axis of the figure has developing countries and developed countries in the order of low-level income/person from left to right. The vertical axis of the figure shows revenue structure of each country (by share of each item: income tax, social security, other domestic taxes, tax on international trade, unclassified revenue, non tax revenue) in the plot. Due to data being unavailable, the figure does not include Laos.

What this figure shows is simple and clear. Let us have a look at Tax on international trade. We can see from the figure that developing countries with low-level income/person rely much more percentage of the total tax revenue on the tax on international trade and no tax revenue than that of developed countries. On the other hand, developed countries account for more percentage of income tax and other domestic tax in the total revenue. The figure is based on the data of 1995 and it is to be hoped that further detailed discussion will be made but it shows that income revenue structures vary much as the economy based on income level/person develops. In the developing countries tax on international trade has more weight in the total revenue because collecting cost of income tax and asset tax is generally high.

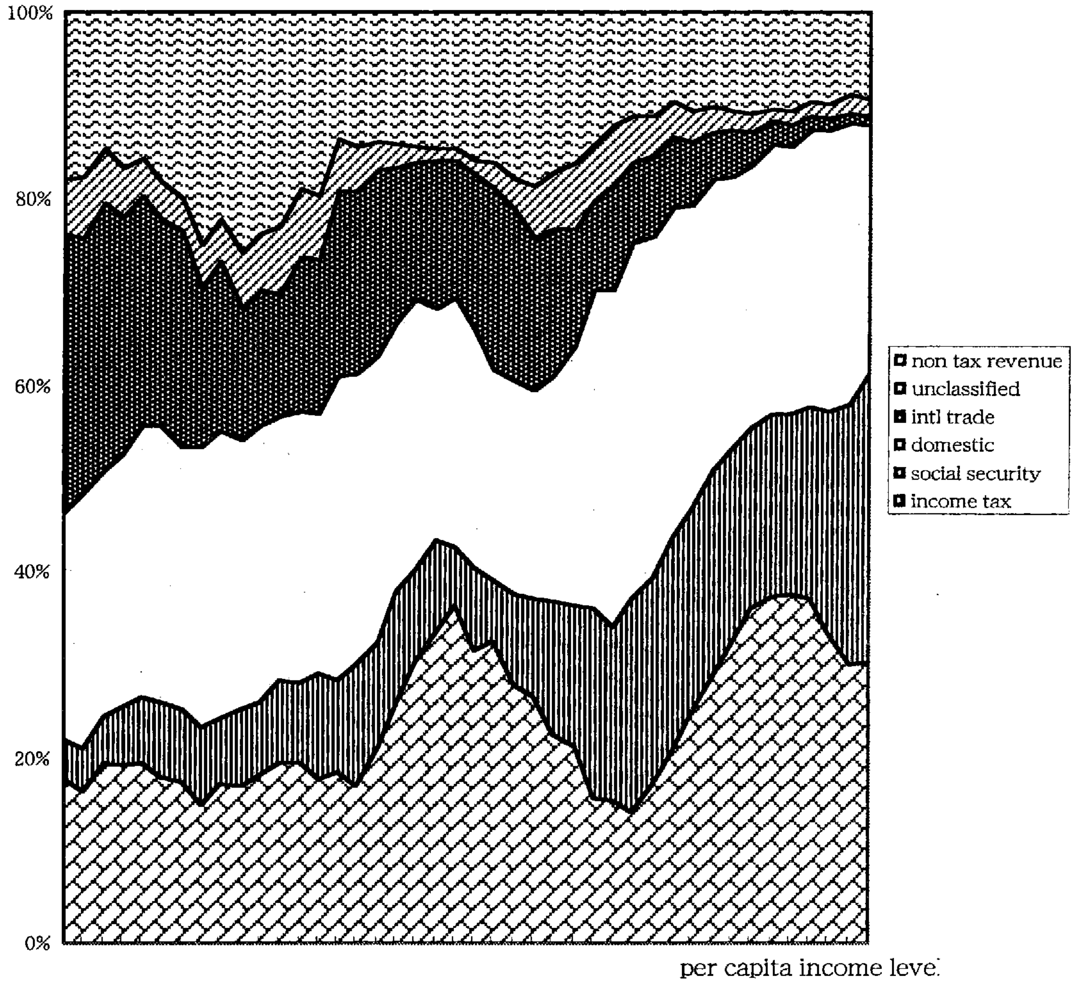


Figure 3 − 1 Tax Revenue Composition & Per Capita Income

Source : Wold Bank, "World Development Report 1997"

3 − 2 − 2 Shift from individual tax to general tax

In Laos tax on international trade accounts for about 20 % of the total revenue at the same period and we can say that tax on international trade is one of the important revenues. Now, Laos officially announced that they would join AFTA, and they are now preparing to observe CEPT scheme. According to the plan, we can see that measures for trade liberalization will be almost completed during the period of 2003 and 2007. In that case, the big problems which the Lao government will face are that they must find new revenue sources to replace tax on international trade which accounts for 20% of the current total tax revenue, and that they must secure stable tax revenue sources which enable them to cover initial investment funds, and operation and maintenance cost after the construction of the projects. Naturally, in this case, strengthening of collecting such tax as income tax and asset tax, strengthening of levying tax on smuggling (actually acquired right of the relative residents) and the like are to be considered but it will not be an easy task for the Lao government to carry out such steps smoothly when we take into account the administrative capacity of the Lao government.

Technical cooperation by international organizations and Japan has already been done to support them in improving works of tax collection with a certain good results but it has not yet contributed to tax revenue increase in a scale and at a speed at which the Government is aiming. Introduction of VAT may not successful in coming years because it needs well-trained personnel and well-developed institution. The experience of neighboring country, Cambodia, shows that applicability of VAT to Laos needs further study and examination.

3－2－3 Enhancement of tax base

In addition to a problem of shifting from tax items at low collecting cost to those at comparatively high cost, there will actually arise a problem for discussion about tax on economic activities shifting from urban areas to rural areas. It may be a very difficult task for the Government to collect tax as planned, because rapid globalization in economy may separate urban areas from rural areas widely and no one knows how fast monetization in economy will actually develop. If they cannot collect tax from rural areas (if rural economy should worsen due to inflation even for a short period of time, this may happen and furthermore it may cost much more money anew if they try to promote collecting tax at rural areas which are very far from urban areas.), the Government may collect tax from where they can and, as a result, such attitude of the Government may give further unknown factors to domestic companies and foreign enterprises. In other words internationalization would make rural economy be isolated from urban economy because the so-called monetization will be developed much more rapidly in the urban area. It means that policy devices to expand the tax base in the rural area may not be successful for the Government. If the Government has an intention to collect tax as much as they can, there is no choice other than imposing on economic activities in urban area that would have negative effect on economic activities.

3－3 Fiscal Expenditure focusing on Operation and Maintenance of foreign aid projects

Because of the lack of fiscal resources, the Lao government is highly dependent on foreign assistance for the investment in infrastructure; foreign assistance accounts for 55% of public investment. Among others, a significant amount of foreign assistance is being invested in the infrastructures in road, health and education sectors, as shown in the table below.

Table 3－1 Public Investment Program FY 2001-2002 (billion kip)

	Domestic budget	Foreign assistance	Total (%)	
TOTAL	1,017.00	1,256.10	2,273.10	100.0%
Economic Sector	638.52	517.63	1156.15	50.9%
Agriculture	319.95	45.22	365.17	16.1%
Industry	66.28	27.08	93.36	4.1%
CTPC*	244.62	444.67	689.29	30.3%
Trade	7.67	0.66	8.33	0.4%
Social Sector	169.52	453.08	622.61	27.39%
Education	85.72	169.74	255.46	11.24%
Health	37.29	141.92	179.21	7.9%
Culture	27.27	59.99	87.26	3.8%
Welfare	19.24	81.43	100.67	4.4%
Others	208.96	285.39	494.35	21.8%

* Construction, Transport, Post and Communications
Source: Public Investment Program, Fiscal Year 2001-2002, CPC

Although local governments' investment plans are approved by the National Assembly and integrated into the Public Investment Programs of CPC (Committee for Planning and Cooperation), current expenditures of each department [2], certain foreign assistance projects, and other expenditures including those which were financed from certain revenues such as wood royalties, are only available at local governments, owing to the lack of monitoring capacity of the central government. In order to figure out the real level of investment and the fiscal capacity to maintain invested infrastructures, four provinces-Luang Prabang, Savannakhet, Champasak and Saravan-were taken as examples and their fiscal data were collected. The following sections present an overview of fiscal allocation and the infrastructure maintenance mechanism in road, agriculture, health and education sectors, and the actual expenditures for infrastructure maintenance in the four sample provinces.

[2] A "department" in this report means provincial offices of ministries.

3－3－1　Road Sector

(1) Fiscal allocation in the sector and the infrastructure maintenance mechanism

Following the Government's decentralization policy, the Ministry of Communication, Transport, Post and Construction (MCTPC) has increasingly delegated its responsibilities to the respective provinces. The MCTPC currently constructs and maintains national roads, while local governments (Department of Communication, Transport, Post and Construction: DCTPC) construct and maintain local roads (provincial roads, district roads and other rural roads).

The central government provides a investment guideline in which priority is given to projects in the following order: ① continuation of foreign financed projects; ② new foreign financed projects; ③ continuation of domestically financed projects; and ④ new domestically financed projects. Since most of the foreign financed projects require the Lao side to provide counterpart funds in order to secure the operation and maintenance of the projects, the Lao government preferentially allocates its domestic budget to counterpart funds. Since maintenance of existing roads is considered as a new domestic project, its priority is low and thus its budget is often slashed when the Government does not have sufficient resources.

The MCTPC has officials responsible for monitoring the maintenance conditions of national roads, while maintenance works of local roads are all delegated to the DCTPCs of local governments while the Local Road Division within the Department of Roads of the MCTPC provides technical, institutional and logistic support to the DCTPCs. Neither the MCTPC's nor provinces' budgets are sufficient to maintain their road network. To respond to the growing needs of road maintenance, the Lao government has established a funding system for the maintenance of the road network, under the assistance of the International Development Association (IDA), the Nordic Development Fund (NDF) and the Swedish International Development Cooperation Agency (SIDA). The minimum funding requirements for nine years from 2001 to 2009 were estimated at about US$ 116 million, of which 35% would be financed domestically by the State budget and road user charges (fuel levy and heavy vehicle surcharge, tolls, etc.). 90% of the fund revenue will be used for the national road network, while 10% will be used for the local road network. It is expected that the road user charges will be progressively raised to generate an adequate flow of funds to maintain the entire road network. The effectiveness of this funding mechanism remains to be seen.

(2) Actual investment in infrastructure maintenance in the four provinces

Overall, investment in the maintenance and rehabilitation of roads in the four provinces is quite limited, and thus, the provinces are heavily dependent on foreign assistance for road rehabilitation. The domestic budget of the better-off provinces (Savannakhet and Champasak) is used more on new construction of roads and bridges (six billion kip in Savannakhet and seven billion kip in Champasak) than their rehabilitation (three billion kip in Savannakhet and 0.7 billion kip in Champasak), while a large portion of foreign assistance (65% to 100%) in the road sector of these provinces is invested in rehabilitation (four billion kip in Savannakhet and ten billion kip in Champasak). Luang Prabang increased considerably its investment in road rehabilitation, since counterpart funds are allocated by the central government to match the foreign assistance (eight billion kip of domestic budget vis-à-vis 34 billion kip of foreign assistance). Saravan does not receive any foreign assistance; its road rehabilitation budget stays at one billion kip in FY 2001-2002.

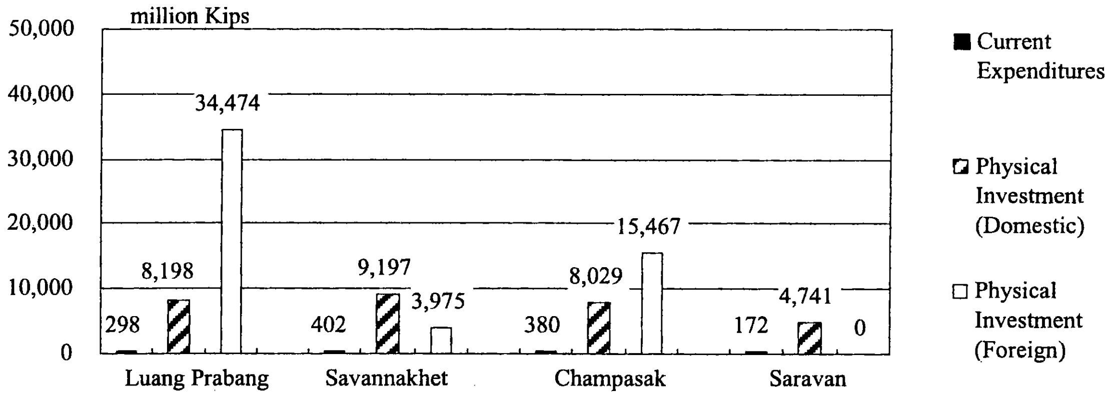


Figure 3 — 2 Provincial Budget in the Road Sector, FY 2001-2002

Source : Department of CTPC in the four provinces:

3 — 3 — 2 Agriculture Sector

(1) Fiscal allocation in the sector and the infrastructure maintenance mechanism

Since 1996 when the Government adopted the decentralization policy, responsibility for most agricultural projects has been transferred to local governments. As a result, the budget of the Ministry of Agriculture and Forestry (MAF) currently represents only 4% of the total capital expenditures of the agriculture and forestry sector. Local irrigation schemes are operated and managed by water user groups, while the MAF provides them with technical and managerial advice. Foreign donors and NGOs are also supporting water user groups. In some irrigation schemes, a sufficient amount is collected to cover periodic maintenance and repairs, while others collect fees only for electricity charges (Background Papers, Public Expenditure Review, World Bank, February 1997).

The following is stated in the Public Expenditure Review by the World Bank on the sustainability of irrigation schemes: "In principle, the existing regulations provide a framework for sustainable and cost-effective management of irrigation systems, especially in cases where village involvement in planning, design and construction was high. However, in the past such involvement was lacking for almost all but the smallest schemes carried out by individual villages with unusually extensive experience managing their own temporary irrigation structures. For the medium-size and larger schemes, effective management is nearly always beyond the technical and organizational capacity of village-level authorities. A provision exists in the regulations for the Government to manage large or internationally bid projects "for a certain period of time in order to assist the farmers" before handing over responsibility to the WUGs, but funds have not been provided to provincial authorities (or the Department of Irrigation) to adequately maintain irrigation assets. In consequence, most of the-larger irrigation schemes have been poorly maintained, are grossly underutilized, or have simply shutdown."

(2) Actual investment in infrastructure maintenance in the four provinces

Since the operation and maintenance of irrigation schemes are handed over to WUGs as stated in section (1) above, most of capital investment in the agriculture sector, both foreign assistance and domestic budget, is directed to the construction of irrigation facilities including reservoirs and for the purchase of irrigation pumps, while the budget for maintenance and rehabilitation of these facilities/equipment is negligible. Local officials are generally disinterested in the actual operational status of irrigation facilities that are handed over to WUGs. Since cash-flow analysis is not sufficiently conducted prior to the investment, many WUGs are apparently not able to prepare savings for the future replacement of facilities. It is expected that a considerable size of fiscal support for the rehabilitation or replacement of irrigation facilities will be needed in the near future, taking into consideration the relative large size of new investment in this sector.

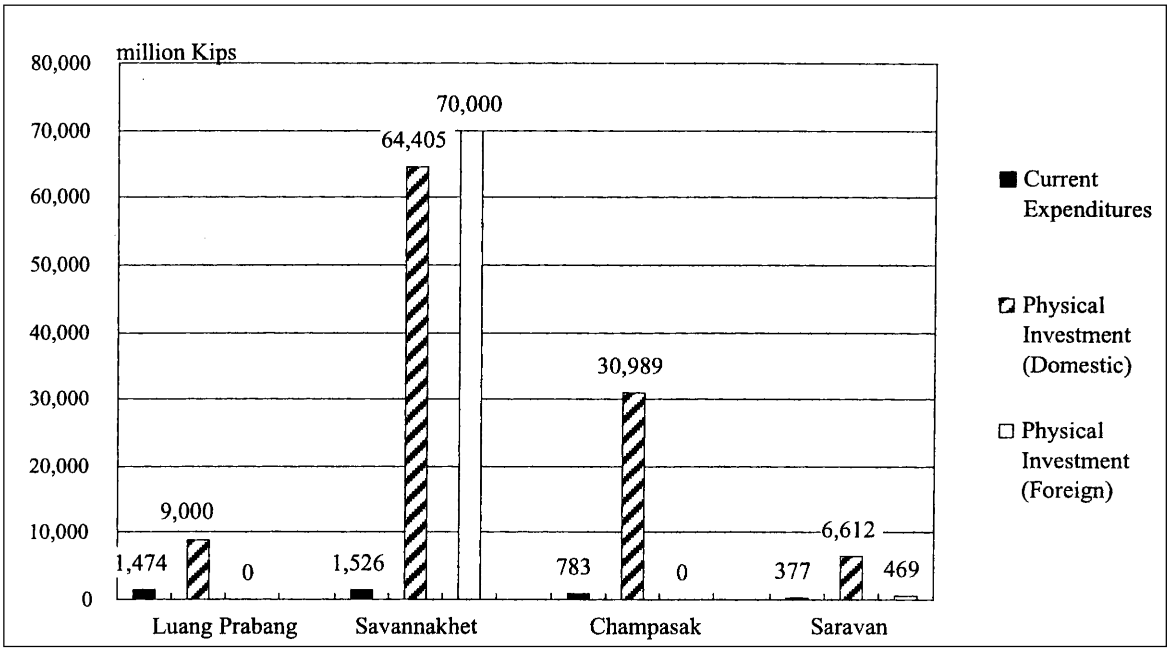


Figure 3 — 3　Provincial Budget in the Agriculture and Forestry Sector, FY 2001-2002

Source : DOAF in the four provinces

3 — 3 — 3　Health Sector

(1) Fiscal allocation in the sector and the infrastructure maintenance mechanism

Due to the policy orientation toward poverty alleviation, the planned capital expenditure for public health increased from 11.5 billion kip in FY 2000/2001 to 74.5 billion kip in FY 2001/2002. Although the Lao government increased the allocation of the Public Investment Program (PIP) in the Ministry of Health (MOH) by 60%, the increase in expenditures was mostly due to the increase in foreign assistance (2.6 billion kip to 60 billion kip).

Conditions of local medical facilities are seemingly quite poor. Local hospitals and dispensaries are managed at local levels while the MOH manages 15 national hospitals. Although the MOH coordinates foreign assistance to support local medical facilities, it does not provide any direct subsidies to them nor monitor their operations. Even at the central level, national hospitals' revenues including the subsidies/budget provided by the MOH are apparently not sufficient to cover their maintenance and operation costs. Heavy capital investments in the health sector would make the O/M costs even higher for these hospitals, widening the gap between the revenues and the costs.

(2) Actual investment in infrastructure maintenance in the four provinces

In the health sector, the majority of the state budget is used for current expenditures, mostly salary of medical or administrative staff, while foreign assistance is directed to specific operational activities (primary health care, HIV, reproductive health, etc.) and capital expenditures (construction of hospitals and health centers). The domestic capital budget is considerably limited, and only used for the construction of small-sized district hospitals and health centers which are urgently needed; practically no budget is available for the maintenance of medical facilities. Among others, the dependency of Luang Prabang Province on foreign assistance for capital investment is significantly high.

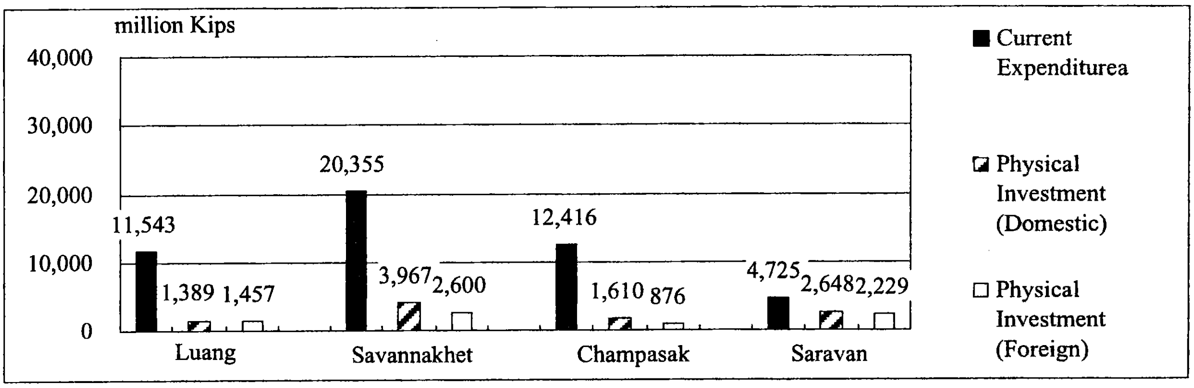


Figure 3 — 4 Provincial Budget in the Health Sector, FY 2001-2002

Source : DOAF in the four provinces

3 — 3 — 4 Education Sector

(1) Fiscal allocation in the sector and the infrastructure maintenance mechanism

In accordance with the Government's decentralization policy, local governments finance and manage all primary and secondary schools while the Ministry of Education (MOE) manages national universities, technical schools at the national level, and teacher training. The MOE increased its planned capital expenditures from 80 billion kip in FY 2001/2002 to 181 billion kip in FY 2001/2002, while local governments also increased their budget allocation in education. However, in spite of the increased planned budget allocation for capital expenditures in education, some of the poorer provinces are, in fact, not able to execute the budget as planned due to a cut in central government's subsidies or the respective provinces' ineffective tax collection. Although the central government gives preferential budget allocation (counterpart funds) to those Departments of Education (DOE) that receive foreign assistance, the counterpart funds only cover the operation and maintenance costs during the period of the foreign assistance; afterwards, budget priority is given to other new foreign financed projects, and local governments are not able to allocate sufficient budget to maintain their education facilities financed by foreign donors. In FY 2001/2002, counterpart funds account for a half of all domestic capital expenditure in the education sector.

(2) Actual investment in infrastructure maintenance in the four provinces

In the education sector, the proportion of the current expenditures in the total sector budget is even higher than that in the health sector; capital expenditures account for only 10% to 20% of the total expenditures in each of the four provinces. Foreign assistance and the small amount of capital budget are mostly used for the replacement of old school buildings. Small-scale grants by NGOs and the Japanese embassy are most often used for this purpose. There is practically no budget allocation for the maintenance of existing school buildings; schools are usually maintained by parents' association or by local communities, in the forms of cash contribution or labor, while the local government provides construction materials (cement, wood, etc.) in some cases.

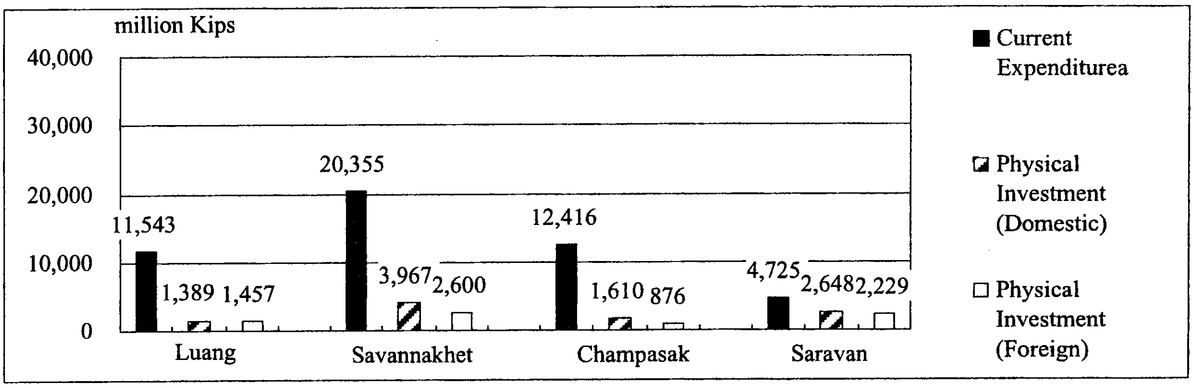


Figure 3 — 5 Provincial Budget in the Education Sector, FY 2001-2002

Source : DOAF in the four provinces

3 — 3 — 5 Concluding remarks

Foreign donors should take into consideration the following aspects when investing in infrastructure in Laos.

(1) Trade-off between new investment and maintenance

From the perspective of economic efficiency, investments in the maintenance of existing infrastructure should be given priority to investments in new infrastructure. Negligence of proper maintenance of existing infrastructure would shorten the life of infrastructure, which results in an even heavier burden on the future budget of the Government. When the expected economic benefits do not materialize due to the deterioration of infrastructure, the country's economic development will be slowed down, making repayment of foreign debt even more difficult.

In Laos, counterpart funds are given budgetary precedence over other domestic capital expenditures. It thus follows that provincial governments and line ministries also give priority to new foreign financed projects in order to maximize the allocation of the budget. Given the Lao government's limited budgetary resources, foreign donors should be aware of the trade-offs between new investment and maintenance.

(2) Appropriate size and specifications of investment in agriculture, health and education sectors

Local communities or beneficiaries are expected to maintain constructed facilities in agriculture, health and education sectors, since local governments do not have fiscal resources to maintain these facilities. As such, it is imperative that these facilities are easily maintained by local community/people, in terms of technique and cost. Based on this recognition, local materials must be maximally used and an appropriate investment size must be pursued.

(3) Fiscal burden of road maintenance

Although a funding system for road maintenance was created, the size of the fund is by no means sufficient to maintain all the road infrastructures in Laos. Foreign donors should be aware that although new road construction will become a driving force for economic development of the country, its maintenance requirement provides a severe burden on the state budget, and thus, the risk that the quality of invested infrastructures deteriorates without proper maintenance activities is high. Therefore, in investing in new road infrastructures, foreign donors should seriously consider not only economic effects of the investment but also its burden on future capital expenditures.

3－4 Fiscal Decentralization

3－4－1 Recent Trend of Overall Fiscal Balance

At the 54th World Bank-IMF joint Annual Meeting, October 1999, the Lao government stated that it was going to exert efforts toward fiscal consolidation, with a revenue collection target of about 12 % of GDP. Commencing in late 1999, the exchange rate value of the Kip stabilized and the inflation rate began declining rapidly; the monthly inflation rate has been close to zero. At the Round Table Meeting in November 2000, the donor community indicated that macroeconomic management and the reform process should be treated as fundamental issues. (ADB, April 2000).

As a result of the efforts in increasing tax revenues through the tax and custom administration reform under the assistance of UNDP/IMF, the tax revenue increased from 11% of GDP in 1998/1999 to 14% in FY 1999/2000 (Table 3 — 2). The Government successfully contained the expenditure at 20% of GDP in 1999/2000, compressing the overall deficit to 2.6% of GDP after grants (Table 3 — 3).

However, the Government has failed to further improve the fiscal balance; the revenue in FY 2000/2001 is estimated to have decreased to 12% of GDP. The Government ordered line ministries to cut, suspend or delay a substantial number of projects in accordance with the following priority; 1) continuation of foreign assistance projects; 2) new foreign assistance projects; 3) continuation of domestically financed projects; and 4) new domestically financed projects. This means that introduction of foreign financing was promoted at the expense of the maintenance of existing infrastructures since the latter is mostly financed from domestic sources.

On the other hand, the expenditure of the local governments has been executed in accordance with the original budget plan in spite of the revenue shortfall at the central level; the local expenditure is actually beyond the control of the central government. The deficiencies in the fiscal decentralization framework constitute one of the major reasons of the revenue shortfall and the inability to control local governments' expenditure. This will be discussed in the following sections.

Table3 − 2 Lao PDR: State Revenue, 1998/1999-2000/2001(in percent of GDP)

	1998/1999	1999/2000	2000/2001	
	(Actual)	(Actual)	(Plan)	(Estimate)
Total Revenue	10.9	13.9	15.2	11.9
Tax Revenue	8.5	10.6	11.7	8.9
Tax Department	5.7	6.7	8.8	6.3
Profit tax	0.9	1.5	2.1	1.0
Income tax	0.8	0.9	1.2	0.8
Turnover tax	1.8	2.3	2.5	2.0
Excise tax	1.8	1.8	2.3	2.1
Other fees	0.4	0.4	0.7	0.5
Custom Department	1.4	1.4	1.7	1.5
Import duties	1.1	1.0	1.3	0.9
Export duties	0.3	0.3	0.4	0.6
Land and House Tax	0.1	0.1	0.1	0.1
Business Licences	0.0	0.0	0.0	0.0
Registration fees	0.1	0.1	0.1	0.1
Natural Resources taxes	0.1	0.1	0.1	0.1
Timber royalties	1.0	2.1	0.8	0.8
Hydro-power royalties	0.2	0.2	0.1	0.0
Nontax revenue	2.4	3.2	3.6	3.0
Leasing fees	0.1	0.1	0.1	0.2
Concessions	0.0	0.0	0.0	0.0
Fines	0.1	0.1	0.2	0.1
Administration fees	0.1	0.1	0.1	0.1
Depreciation/dividends	0.3	0.3	1.4	0.5
Interest	1.0	0.6	0.3	0.6
Overlflight Rights	0.5	1.0	0.8	0.6
Irrigation fees, Others	0.0	0.3	0.1	0.1
Asset Sale	0.1	0.1	0.3	0.1
Capital Return	0.3	0.6	0.3	0.6

Source: Data provided by Lao Ministry of Finance, and MAPS Estimates

Table3 — 3 Lao PDR : General Government Operations, 1994/1995-2000/2001

(in persent of GDP)

	1994/95 (Actual)	1995/96 (Actual)	1996/97 (Actual)	1997/98 (Actual)	1998/99 (Actual)	1998/99 (Actual)	1999/2000 (Actual)	2000/2001 (Estimate)
Revenue	12.2	13.0	11.3	11.2	12.7	10.9	13.9	11.9
Tax	10.2	10.8	9.3	8.8	10.7	8.5	10.6	8.9
Nontax	2.0	2.2	1.9	2.3	2.1	2.4	3.2	3.0
Expenditure	21.9	22.1	21.3	26.9	21.1	22.7	20.2	20.3
Current expenditure	10.8	10.2	9.5	8.1	9.1	6.7	6.3	6.9
Of which: Wages and salaries	5.2	4.8	4.5	3.5	3.5	2.8	2.6	2.3
Capital expenditure	11.1	11.9	11.8	18.8	12.0	16.0	13.9	13.4
Current balance 1/	1.4	2.8	1.8	3.0	3.6	4.2	7.6	5.0
Grants	5.5	3.5	3.5	5.8	3.1	4.5	3.7	2.8
Overall balance								
Including grants	-4.2	-5.6	-6.5	-10.0	-5.3	-7.3	-2.6	-5.6
Excluding grants	-9.7	-9.1	-10.0	-15.8	-8.4	-11.8	-6.3	-8.4
Domestic financing 2/	-0.4	-1.1	0.9	3.3	0.1	-3.2	-3.8	0.4
Foreign financing	4.6	6.7	5.6	6.7	5.1	10.5	6.4	5.2
Memorandum item:								
GDP fiscal year (in billions of Kip)	1, 323.0	1,631.0	2,029.0	3,290.0	5,187.0	8,329.0	12,848.0	14,950.0
(Source)	IMF	IMF	IMF	IMF	IMF	MOF+MAPS	MOF+MAPS	MOF+MAPS

Source: Data provided by Lao authorities, and MAPS estimates

1/ Excluding grants

2/ Comprising bank and nonbank financing, and receipts from government asset sales

3 — 4 — 2 Budget Procedures

The Budget Law of 1994 stipulates that all revenues and expenses of the State must be entered into the "State Budget". The State Budget is composed of the "Government Budget" and the "Local Budget". Under the Government's decentralization policy, Decree # 192 was signed by the Prime Minister on November 2, 1999, which expands the expenditure responsibilities of the provincial and district levels of the Government.

Provincial governments are composed of the cabinet and the branch offices ("Departments") of the line ministries. Although line ministries formally assign the staff to these branch offices, it would be appropriate to consider these officials to belong to provinces since they originated from respective provinces and the provincial governments pay their salary and have an authority to transfer or even fire them. Early in the calendar year, line ministries and provincial governments submit to the Committee for Planning and Cooperation (CPC) investment proposals for consideration. Proposals at the provincial level are developed by the departments of the province and coordinated by the provincial governor. The investment program assembled by CPC is forwarded to the Ministry of Finance (MOF) for more detailed budget reconciliation. The MOF must ensure that the budget can accommodate the requirements for counterpart funds and commitments for recurrent expenditures, while giving priority to the projects financed by foreign assistance. In May/June, the MOF prepares a draft State Budget framework, which is reviewed and revised by the Government and finally approved by the National Assembly (ADB, April 2000). Under the decentralization policy, the provincial share of the budget has been increasing: 30% in 1996/1997 to 40% in FY 2000/2001 (Table 3 — 4).

There are several sources of revenues for the State government. Tax revenues account for 80% of the total State revenue while non-tax revenues account for 20%. The Tax Department collects some 70% of the tax revenues (turnover tax, income tax, profit tax and other fees) while the Custom Department collects some 15% of the tax revenues (import and export duties, fees and fines). It should be noted that all tax and non-tax revenues, except for those taxes collected by the Large Taxpayer Unit (LTU) that represents 40% of the Tax Department Revenues, are collected at local levels (Table 3 — 5).

At the beginning of the fiscal year, every province is assigned a certain level of "target" for the collection of taxes. Under the guidelines of the Ministry of Finance, the provinces with a strong revenue base, namely those provinces whose revenue regularly exceeds the expenditure, are expected to transfer the surplus (revenue target minus planned expendi-

Table3 − 4 Lao PDR : General Government Operations, 1994/1995-2000/2001

(in percent of total expenditure)

	'1996/1997			'1999/2000			'2000/2001 /1		
	Total	Current	Capital	Total	Current	Capital	Total	Current	Capital
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Ministries	70.2	63.4	75.1	67.2	71.3	65.4	60.5	72.8	53.1
Public health	2.2	2.4	2.0	0.5	0.9	0.3	0.8	0.9	0.8
Social welfare	4.8	4.2	5.2	2.1	0.5	2.8	2.5	0.8	3.6
Education	7.7	2.7	11.3	2.6	1.9	3.0	3.5	2.8	3.9
Information and culture	1.9	2.2	1.6	1.8	0.5	2.5	0.8	0.6	0.9
Agriculture and forestry	2.6	0.5	4.2	1.9	0.4	2.5	2.4	0.4	3.7
Industry	10.8	0.1	18.5	2.1	0.1	3.1	1.5	0.1	2.4
Communication, transport and post	16.5	0.3	28.3	32.8	0.4	47.5	20.1	0.9	31.7
Commerce	0.0	0.1	0.0	0.0	0.1	0.0	0.1	0.2	0.1
Interior	3.8	7.5	1.1	3.0	8.4	0.6	3.2	7.7	0.5
Defense	12.2	27.8	0.8	8.7	25.3	1.1	9.0	21.6	1.3
Justice	0.1	0.2	0.0	0.0	0.1	0.0	0.1	0.1	0.1
Finance	0.3	0.8	0.0	8.0	24.5	0.5	9.7	24.5	0.7
Prime Minister's Office	6.1	11.7	1.9	1.5	2.6	1.0	4.4	6.3	3.2
Foreign affairs	1.2	2.7	0.1	1.8	5.6	0.1	2.2	5.7	0.0
Committee for Planning and Coordination	0.1	0.2	0.0	0.4	0.1	0.5	0.1	0.1	0.1
Provinces	29.8	36.6	24.9	32.8	28.7	34.6	39.5	27.2	46.9
Phongsali	1.8	1.4	2.1	1.6	0.9	1.8	2.7	0.8	3.9
Louangnamtha	1.7	1.2	2.0	0.9	0.8	0.9	1.1	0.8	1.3
Oudomxai	1.1	1.4	0.9	1.9	0.9	2.4	2.0	1.1	2.6
Bokeo	0.9	1.0	0.8	2.9	0.7	3.9	1.8	0.8	2.4
Louang Prabang	2.1	2.7	1.7	1.2	1.8	1.0	2.3	2.1	2.4
Houaphan	1.2	1.6	0.9	2.5	1.3	3.1	2.2	1.4	2.6
Xaignabouli	1.6	2.3	1.1	1.0	1.4	0.8	2.7	1.6	3.4
Xiang Khoang	1.0	1.6	0.6	1.9	1.3	2.1	2.5	1.3	3.2
Vientiane Municipality	5.2	4.1	6.0	5.4	2.8	6.6	5.9	2.8	7.8
Vientiane Province	1.5	2.5	0.8	1.8	2.0	1.7	2.6	1.9	3.1
Bolikhamxai	1.0	1.5	0.7	1.4	1.0	1.7	1.2	1.0	1.3
Khammouan	1.4	2.2	0.8	1.8	1.7	1.8	2.1	1.8	2.3
Savannakhet	3.2	4.5	2.3	2.7	3.9	2.2	3.1	3.8	2.7
Salavan	1.1	1.6	0.8	1.5	1.0	1.7	2.5	1.2	3.2
Xekong	1.0	0.9	1.0	0.9	0.6	1.1	0.8	0.6	1.0
Champassak	2.6	4.5	1.2	2.3	5.5	0.8	2.4	3.1	2.0
Attapu	0.7	0.8	0.6	0.5	0.7	0.4	0.8	0.8	0.8
Xiasomboun special Region	0.7	0.8	0.6	0.4	0.5	0.4	0.7	0.5	0.8

Source: IMF Recent Economic Developments for 1996/1997 , data provided by Lao Ministry of Finance for 1999/2000 and 2000/2001

1/ Original budget

Table3 － 5 Lao PDR : Tax Revenues (1999/2000)

(in billions of kip)

	Tax Dept. Revenues 1/	Custom Revenues 2/	Land and House Taxes	Taxes on State Property	Dividend	Timber Royalties and Others	Total
Total Revenue	864.4	209.2	10.1	252.4	157.4	285.7	1,779.2
Ministry of Finance	366.3	1.5	0.0	206.9	156.2	285.7	1,016.5
Province Total	498.2	207.7	10.1	45.5	1.2	0.0	762.7
Vientiane Municipality	156.2	99.1	2.5	10.8	1.1		269.8
Phongsali	3.4	1.0	0.3	0.3			5.0
Louangnamtha	9.3	7.8	0.3	0.7			18.2
Oudomxai	4.5	1.3	0.3	0.3	0.0		6.3
Bokeo	8.4	3.6	0.2	0.8			13.0
Luang Prabang	13.0	0.8	0.6	1.4	0.0		15.8
Houaphan	2.0	0.4	0.2	0.3			2.9
Xayabrury	18.5	3.7	0.6	1.1			23.9
Xiang Khoang	7.0	1.8	0.3	0.3			9.3
Vientiane Province	13.8	0.9	0.7	2.7	0.0		18.2
Bolikhamxai	15.8	10.8	0.4	1.9			28.8
Khammouan	48.5	5.7	0.6	5.8			60.6
Savannakhet	134.2	47.4	1.8	4.2	0.0		187.6
Saravan	5.8	8.3	0.4	2.0	0.1		16.5
Xekong	4.1	0.5	0.1	0.6			5.2
Champassak	46.4	11.5	0.7	9.9			68.5
Attapu	5.8	2.7	0.1	0.5	0.0		9.2
Xiasomboun Special Region	1.6	0.3	0	2.0			3.9

Source: Lao Ministry of Finance

1/ Profit Tax, Turnover Tax, Income Tax, and Fees

2/ Import Duties, Export Duties, Fees and Fines ture) to the central government on a monthly basis. Currently, Vientiane Municipality, Savannakhet, Champassak, and Khammouan fall into this category. The revenue sources of the poor provinces whose expenditure regularly exceeds their revenue are their own tax revenues and the subsidies from the central government. If they do not achieve the assigned tax collection target, they have to cut their expenditures. These subsidized provinces and the self-sufficient provinces may keep 100 % of revenues collected in excess of their assigned targets. Prior approval by the central government is not currently required in using the surplus.

3－4－3 Practice of Revenue Transfer between Central and Provincial Governments

Although Decree #192 stipulates that provinces must transfer import duties and turnover and income taxes levied on import goods to the "Government Budget", it is not yet in fact practiced except for Vientiane Municipality. According to the CPC, the four better-off provinces are requested to transfer a fixed amount of the revenue on a monthly basis to the central government, not by tax items. However, these provinces except for Vientiane Municipality transfer only the revenue portion that exceeds their monthly expenditure, namely, the residual. On the other hand, some poor provinces have received only part of the amount of subsidies planned at the beginning of the fiscal year, due to the revenue shortfall at the central level.

In the course of the mission, the Departments of Finance of Louang Prabang, Saravan, Champassak and Savannakhet Provinces were interviewed. The following are the facts found in the interviews.

(1) Louang Prabang Province

Louang Prabang is one of the poor provinces located in the northern region. The subsidies from the central government, 35 billion kip in FY 2000/2001, account for more than half of the provincial revenue. While the tax collection target was 21 billion kip in FY 1999/2000, the province collected 23 billion kip. The surplus, two billion kip, was used to finance emergency expenditures of the province; prior approval by the central government on these expenditures was not required, according to the province. Under the Government's poverty alleviation policy, the planned expenditure was raised to 67 billion kip in FY 2000/2001, to be financed by the taxes (23 billion kip) and the subsidies (44 billion kip). The province again succeeded in achieving the target in FY 2000/2001 and gained a surplus of three billion kip.

Louang Prabang Province

(1999/2000)

Plan

Revenue	Expenditure
Target for Tax Collection = 21 billion	56 billion (Capital: 30 billion, Current: 26 billion)
Central Government Subsidy = 35 billion	

Actual

Revenue	Expenditure
Tax Collected = 23 billion	58 billion
Central Government Subsidy = 35 billion	o.w.Emergency Expenditure = 2 billion

(2000/2001)

Plan

Revenue	Expenditure
Target for Tax Collection = 23 billion	67 billion
Central Government Subsidy = 44 billion	

Actual

Revenue	Expenditure
Tax Collected = 26 billion	70 billion
Central Government Subsidy = 44 billion	o.w. Emergency Expenditure= 3 billion

* Breakdown of Revenues:

Tax: 82%
Custom: 5%
Land Tax: 5%
Leasing of State Property: 8%

* Use of Surplus:
100% for the Province. The Central Government's approval is not required.

(2) Saravan Province

Saravan Province is one of the poor provinces in the Southern Region. The budget size of Saravan Province is smaller than that of Louang Prabang, and so are the subsidies. In FY 1999/2000, the tax collection by the province exceeded the target (11 billion kip) by two billion kip; all the surplus was used for emergency expenditures of the province.

For the same reason as Louang Prabang, the planned expenditure was raised to 34 billion kip in FY 2000/2001, to be financed by the tax revenues (22 billion kip) and subsidies (12 billion kip). However, the provincial revenue target was optimistic; the tax collection ended up with 18 billion kip. Furthermore, due to the overall revenue shortfall, the central government failed to transfer the planned amount of subsidies; five billion kip are unpaid. In spite of the shortfall of the provincial revenues, the province has executed the expenditure as planned, apparently producing arrears vis-   vis local private contractors.

(3) Champassak Province

Champassak Province is one of the four better-off provinces that are required to transfer part of their revenues to the central government. In FY 1999/2000, the planned expenditure was 38 billion kip while the revenue target was set at 103 billion kip; the balance, 65 billion kip, was to be transferred to the central government. Since the actual revenue exceeded the target by 17 billion kip, the province and the central government shared the surplus by fifty-fifty, raising the province's year-end expenditure to 46.5 billion kip.

In FY 2000/2001, under the fiscal decentralization, the planned expenditure of the province jumped to 73 billion, and the tax revenue target was set at 127 billion keps. However, the province was not able to achieve the target; the year-end tax revenue stood at 115 billion kip, 12 billion kip short of the target. Since the province gives priority to its own expenditures, the actual provincial expenditure was not affected by the revenue shortfall and only the transfer to the central government was decreased by 12 billion kip.

Saravan Province

(1999/2000)

Plan

Revenue	Expenditure
Target for Tax Collection = 11 billion	14 billion
Central Gov't Subsidy = 3 billion	

Actual

Revenue	Expenditure
Tax Collected = 13 billion	16 billion
Central Gov't Subsidy = 3 billion	o.w. Emergency Expenditure= 2 billion

* Use of Surplus:
100% for the Province. The Central Government's approval is not required.

(2000/2001)

Plan

Revenue	Expenditure
Target for Tax Collection = 22 billion	34 billion
Central Government Subsidy = 12 billion	

Actual

Revenue	Expenditure
Tax Collected = 18billion	34 billion
Central Gov't Subsidy = 7 billion	
Revenue Shortfall = 4 billion	o.w. debt to the private = 9 billion
Subsidy not yet received = 5 billion	

* Breakdown of Revenues:

Tax: 43%
Custom: 44%
Land Tax: 4%
Leasing of State Property: 9%

Champassak Province

(1999/2000)

Plan

Revenue	Expenditure
Target for Tax Collection = 103 billion	38 billion
	Transfer to the Central Government = 65 billion

Actual

Revenue	Expenditure
Tax Collected = 120 billion	46.5 billion
	Transfer to the Central Government = 73.5 billion

(2000/2001)

Plan

Revenue	Expenditure
Target for Tax Collection = 127 billion	73 billion
	Transfer to the Central Government = 54 billion

Actual (Estimate)

Revenue	Expenditure
Tax Collected = 115 billion	73 billion
	Transfer to the Central Gov't = 42 billion

* Breakdown of Revenues:

Tax: 36%
Custom: 8%
Land Tax: 1%
Revenues from State Property: 55%

* Use of Surplus:
50% of the Surplus is transferred to the Central Government.

(4) Savannakhet Province

Savannakhet Province accounts for some 10% of the total State revenue, having the second largest tax base next to Vientiane Municipality. Although the planned expenditure of the province was 43 billion kip in FY 1999/2000, it was agreed with the central government that the province would receive a bonus, maximally 23 billion kip, contingent on the performance of the tax collection. The province collected 189 billion kip, 11 billion kip short of the target, and received a bonus of 15 billion kip. Approval of the central government was not requested for the utilization of the bonus.

For FY 2000/2001, the provincial expenditure of 100 billion kip was agreed with the central government, while the tax target was set at 265 billion kip. If the province had achieved the target, both the province and the central government would have been better off. However, the actual tax revenues turned out to be far below the target, estimated at 150 billion kip. Since the expenditures of the province were executed as originally planned, only the transfer to the central government decreased, from 165 billion kip to 50 billion kip. It should be noted that in spite of the significant decrease of tax revenues compared to the previous year, the province increased its expenditure from 58 billion kip to 100 billion kip.

Savannakhet Province

(1999/2000)

Plan

Revenue | Expenditure

Target for Tax Collection = 200 billion

43 billion

Expected Bonus = 23 billion

Transfer to the Central Government = 134 billion

Actual

Revenue | Expenditure

Tax Collected = 189 billion

58 billion

o.w. bonus = 15 billion

Transfer to the Central Government = 131 billion

(2000/2001)

Plan

Revenue | Expenditure

Target for Tax Collection = 265 billion

100 billion

Transfer to the Central Government = 165 billion

Actual (Estimate)

Revenue | Expenditure

Tax Collected = 150 billion

100 billion

Transfer to the Central Gov't = 50 billion

* Breakdown of Revenues:

Tax: 70%
Custom: 25 %
Land Tax: 1%
Leasing of State Property: 4 %

* Use of Bonus:
100% for the Province. The Central Government's approval is not required

(5) From the all findings above, the following systemic problems are identified:

(a) By exaggerating the tax collection forecast, better-off provincial governments are able to increase their planned expenditure level. The central government agrees on the high level of their expenditures since the transfer to the central government is also envisaged to increase. However, when the tax collection does not reach the target, only the central government revenues are reduced while the provincial expenditures untouched.

(b) The overall expenditure level of the central government is based on the forecasted aggregate tax revenues. The overestimated tax revenue makes the State Budget unrealistic, resulting in the gap between the revenue and the expenditure. Consequently, line ministries' expenditures and subsidies to poor provinces are slashed in the middle of the fiscal year, and/or payments to contractors are delayed.

(c) When poor provinces want to increase their expenditures, they must also raise the tax collection target. To respond to their tax increase efforts, the central government would also increase the subsidies. The provinces not conscious of fiscal management execute all the expenditures regardless of a revenue shortfall and/or a cut in subsidies by the central government. Arrears of the provincial governments toward local contractors would cause serious negative impact to the local economies.

(d) According to the tax regulations, better-off provinces receive half of the surplus after achieving the target. Once the provinces realize that their tax collection of the current year will not exceed the target, they lose the incentive to further increase tax collection beyond the level of their expenditure, since all the revenues beyond the expenditures are simply absorbed by the central government.

Budgetary system in Lao PDR is in fact highly decentralized: Governors are as powerful as Ministers; 60 % of the State revenues are collected and 40 % of the State expenditures are executed at the provincial level, branch office staff of the line ministries are de fact under the authority of the province; and most of the projects within the province are proposed and implemented at the provincial level while line ministries' functions are technical advice and coordination with foreign assistance. Although the delegation of authority of decision-making and execution of expenditures to the local governments is effective in responding to the local needs, the central government has to reallocate the resources between provinces in order to achieve the national development strategy such as poverty alleviation

The tax and custom collection is significantly improving through the assistance of UNDP and IMF, which will eventually lead to an increase of the State Revenue. However, in order to achieve the fiscal balance of the central government, the framework of fiscal decentralization must be reconsidered so that the central government ensures the transfer of revenues from provinces and controls excessive expenditure of provinces.

Under the Decree #192, the central government tries to capture all the custom revenues and turnover, income and profit taxes levied on imported goods. Figure 3 — 6 shows the tax revenues from domestic goods and imported goods by province. If Decree # 192 is implemented, almost half of the tax revenues of each province would be captured by the central government. However, the theory and the practice are mostly different in Lao PDR, as Section 3 shows. It is imperative that the implementation of Decree # 192 be reinforced by other measures to make sure that all the transfer to the central government materializes, while part of the tax revenues from domestic goods and activities should also be transferred from better-off provinces.

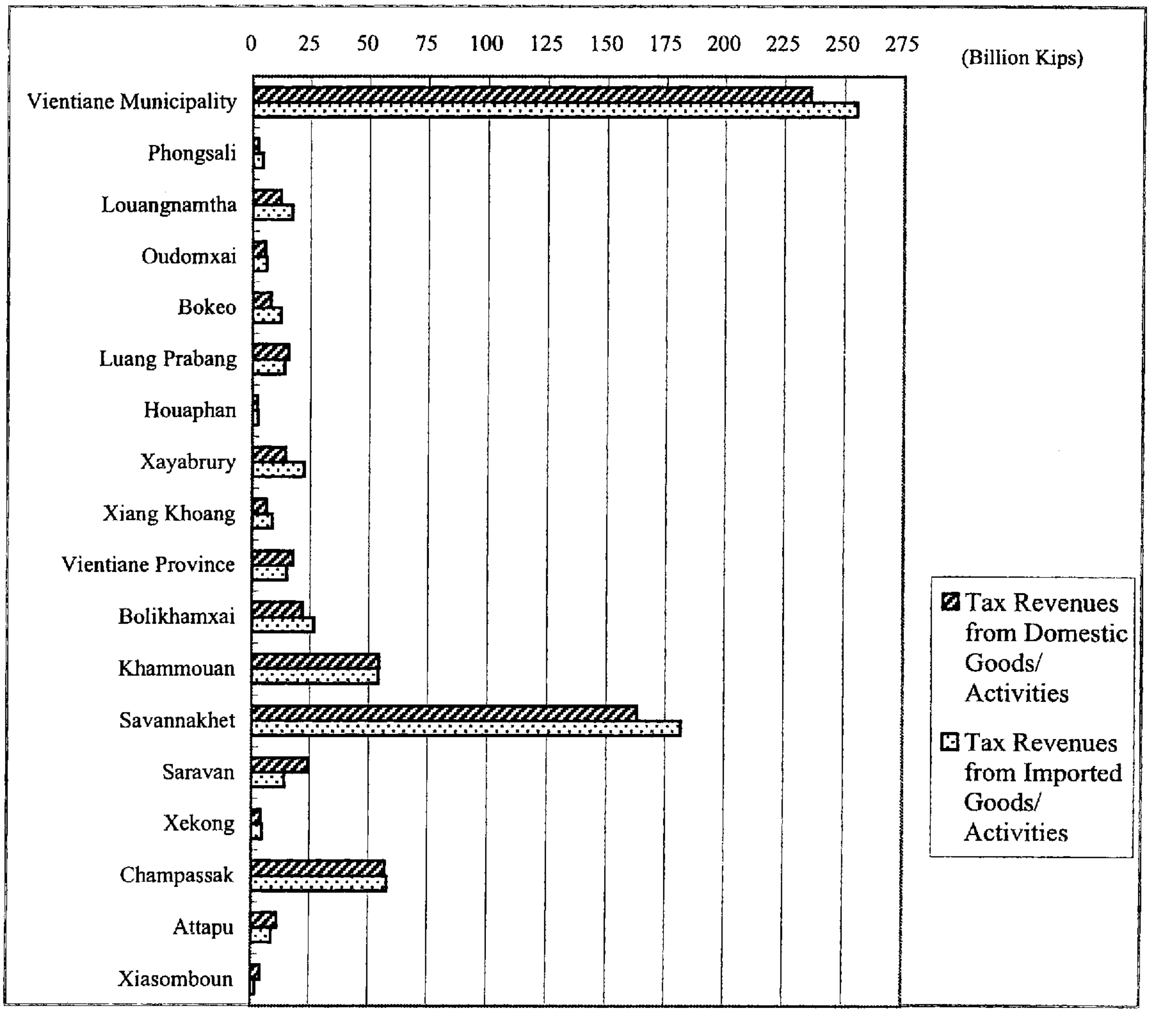
(6) The following are the suggestions to enable the transfer:

(a) Taxes should be separated into "National Taxes" and "Local Taxes", which are to be collected by separate authorities. In order to rule out provincial government's discretion in the transfer of revenues and maximize the tax collection incentives, "National Taxes" must be collected by the national authority while "Local Taxes" must be collected by local authorities. By limiting the resources for the better-off provinces, their expenditures will be contained accordingly.

(b) Custom Revenues should be classified as a National Tax, as stipulated in Decree # 192, in order to strengthen the control of custom activities.

(c) Fiscal disciplines must be strengthened at poor provinces. Clear rules, such as penalties against the expenditure overrun, must be introduced. Tax collection target should be based on the past performance, not based on the expectation of the local governments.

Figure 3 − 6 Tax Revenues from Domestic Goods and Imported Goods (FY 1999/2000)



Source: Data provided by Lao Ministry of Finance, and MAPS Estimates

4. Lao PDR Financial Sector

Khamphouth Sithirath

4－1 An Historical Perspective

(1) New Economic Mechanism (NEM) was initiated in 1988, the development of the Lao financial sector can be divided into three periods. During the first period (1988-1991), the mono-banking system instituted in the State Bank of Lao (SBL) since 1975, was replaced by a two-tier banking system (March 1988). The commercial banking activities of the SBL were separated from central banking function and three of its branches were spun off as independent banks. In 1990, the Central Bank Law (Law No. 4) established Bank of Lao PDR (BOL) as the central bank, in place of SBL. Four more state-owned commercial banks (SOCBs) were created during 1990-1991. All seven SOCBs were under the management control of BOL and each was assigned a geographical area of coverage. A first joint venture bank with 30 % Government equity was also established. The legal and prudential frameworks were inadequate, bank supervision and commercial banking experience scarce, resulting in low performance and increasing non-performing loans (NPLs).

(2) The second period (1992-1995) witnessed an increase in the number of financial institutions in Lao PDR. The Prime Minister Decree No. 3 of 1992 on the Management of Commercial Banks and Other Financial Institutions, which defined banking business and the requirements for the establishment and operations of commercial banks, paved the way for the establishment of the private banks. Six branches of Thai banks, a branch of a Malaysian bank, and a second joint venture bank were established. In 1993, the Agriculture Promotion Bank was created by Prime Minister Decree to act as the country's agricultural development bank. A number of foreign exchange bureaus, mostly owned by the commercial banks and some by individuals, were opened. Despite improvements brought to the legal and prudential framework the financial health of the system did not improve due to weak enforcement: non-performing loans of SOCBs accounted for over 35 % of their outstanding loan portfolios in 1994. To meet capital adequacy requirements, the Government proceeded with a first round of recapitalization of the SOCBs. In 1995,

the Law on Bank of Lao PDR improved on the 1990 Central Bank Law.

(3) During the third period (1996-to date) improvements were made to banks' legal and regulatory framework. Six prudential regulations for commercial banks and the Agriculture Promotion Bank (APB) were also issued by BOL in 1996, and a new regulation on asset classification and loss provisions was promulgated in 1998. A new chart of accounts was also introduced for the commercial banks in 1996. In 1997, the Decree Law on Management of Commercial Banks and Other Financial Institutions replaced the Decree No. 3 of 1992, making the board of directors the policy making body of each SOCB and vesting in the Ministry of Finance (MOF) the power to appoint the chairman and other members of the board. Recently, in 1999, the Law on Bank of Lao PDR was amended; one amendment consisted in removing the power of BOL to appoint key executives of SOCBs. The continuing SOCBs' poor performance was revealed by audits on 1996 and 1997 accounts of the SOCBs. In 1998, Government launched a program to consolidate, corporatize and recapitalize the SOCBs. Recapitalization has yet to take place and more important a plan developed to ensure long term sustainability of those resulting institutions including adequate institutional arrangements and incentive framework. Despite improvements in the framework, implementation and enforcement has remained weak throughout the second and third period.

4－2 Financial Systems and Growth-Some Cross-Country Evidence

(1) A healthy financial system is essential to sustainable economic development. In order to support economic growth, the financial system should be effective at: mobilizing domestic savings; facilitating trading of goods, services and financial contracts; providing an efficient trading, hedging and pooling of risks; allocating capital; and, exerting corporate control. Moreover, the system should offer a variety of financial services adapted to diversified economic agents. And it should, as needed, be effective at attracting foreign capital for the financing of productive investments-by complementing rather than substituting for domestic sources of financing.

(2) In many developing countries, most financial systems fall short of the above "ideal" features: financial systems tend to be shallow, and the financial intermediation process costly as well as lacking efficiency, transparency and stability. The number of countries

experiencing significant banking problems has increased substantially in the past decade, with many of these countries witnessing major, costly financial crises.

(3) Beyond the short-term effects suffered by those economies, these shortcomings have longer-term consequences for rates of growth achieved. Indeed, evidence worldwide points not only to the existence of a strong, positive link between financial development and economic growth, but also to the fact that the level of financial development in a given country is a good predictor of future economic development [1]. Cross-country relationships between economic growth and aggregate measures of financial sector performance show, in particular, that:

- financial sector depth (as measured by the ratio of financial assets to GDP) is strongly correlated to real per capita GDP;
- the share of credit provided by commercial banks (measured by the ratio of commercial bank credit to the sum of bank credit and central bank domestic assets) is closely correlated to real income, suggesting that banks are more likely to efficiently allocate credit for productive uses than the central bank through centrally-directed credit programs; and
- the share of credit allocated to the private sector (measured by the ratio of credit allocated to private enterprises to total domestic credit, excluding credit to banks), as well as the ratio of credit to the private sector to GDP, are both correlated in a statistically significant way to per capita GDP.

(4) These findings support the existence of a strong positive relationship between the various indicators of financial development and key growth indicators. Deepened financial systems and an efficient allocation of resources by financial intermediaries lead to accelerated rates of growth of real per capita income, as well as to faster capital accumulation and productivity growth. Moreover, financial sector development does not merely reflect higher levels of economic activity, but it also helps promote economic performance, indicating that "the initial level of financial development is a good predictor of subsequent rates of economic growth, physical capital accumulation, and economic efficiency improvements over the next thirty years, even after controlling for income, education, political stability, and measures of monetary, trade, and fiscal policy." [2]

1) See Levine, Ross: "Financial Development and Economic Growth: Views and Agenda," Policy Research Working Paper No. 1678, October 1996.
2) Op.cit., page 34.

(5) Although the data have to be interpreted with caution, the results point to a need to an increase of Lao's M2/GDP ratio to about 50%,[3] from the low average 13% achieved in the past years. This illustrates that the financial sector will act as a heavy constraint if not dealt with in a decisive manner. To be noted that M2 as defined here, is the result of a demand for the real money stock linked to economic activity and cannot be set by a simple decision to supply the targeted amount. Also, the level of M2/GDP depends on the structure of the financial system; it needs to be compared with countries where the financial system is dominated by banks as opposed to capital markets.

(6) Moreover, as can be seen from Table 4－1, M2/GDP is among the lowest in the world in Lao PDR. Former planned economies (*) tend to have lower financial depth.

Table 4－1 Financial Depth: Country Comparison (1997)

	M2/GDP (%)
Lao PDR (*)	18
Vietnam (*)	24
Thailand	90
Bangladesh	38
Burkina Faso (*)	25

(7) While the objective of raising M2/GDP to 50 % appears ambitious in terms of the financial sector, it does not appear very ambitious in terms of reducing poverty. A 4 %/capita GDP growth would only raise Lao per capita GDP to US$ 895 in 22 years. Hence, Lao PDR would only graduate from the least developed countries i.e., IBRD eligibility in 2022 at the earliest, while remaining a developing country. Lao PDR's future GDP per capita would still remain below today's average GDP per capita in East Asia and Pacific

3) We use Easterly-Levine's "best" regressions in which the regression coefficient for the "financial depth" (M2/GDP) variables is 0.011. Assuming a "target" rate of growth of per capita real GDP of 4 % we end up with the following factors augmenting the "observed" average (M2/GDP) ratio for Laos in the 1990s (13 %):

Estimated (M2/GDP) coefficient	4% Growth in real per capita GDP
.011	(.04/.011=3.63) x 0.13= 0.473

In other words, ceteris paribus, to achieve in the 1990s a 4 % rate of real per capita GDP growth would have required an (M2/GDP) ratio 3.6 times higher than the average observed (M2/GDP) ratio. That is, instead of an (M2/GDP) = 13 % it would have been required to reach ratios of almost 50 %. If real per capita GDP growth is to reach 4 %, then the "required" (M2/GDP) ratio should be as high as 50 %. The same ratio would be required going forward.

(US$ 990). But even this result should presently be considered optimistic in Lao PDR as the country is facing additional challenges.

4－3 Financial Systems and Macroeconomic Stability

(1) A shallow financial system which makes limited or little contributions to growth is not the only problem facing Lao PDR. A shallow financial system actually also feeds into macroeconomic instability because the economy is vulnerable to small monetary shocks as recent history has shown. Improvements in the financial sector will also have the effect of improving macroeconomic management.

(2) The lack of financial depth makes monetary discipline difficult to enforce, as relatively small fiscal deficits will generate large monetary and inflationary pressures. For example, this vulnerability was evidenced by off-budget investments financed in 1997 by the BOL to the tune of about 5% of GDP. This resulted in a monetary expansion of almost 100% at this level of financial depth. These policy actions accelerated the depreciation of the Kip, and quickly fed into higher prices in an undermonetized and dollarized economy.

(3) In the case of Lao PDR, the financial sector and the macroeconomy are struggling in a vicious circle. Confidence in the financial sector and in the currency has been undermined by some inadequate policies resulting in a low savings rate and a shallow financial system. In turn, this shallowness and other inefficiencies (as we will see later) are contributing to macroeconomic instability.

(4) A high level of inflation is detrimental to the economy. A stable and balanced economic environment, with low inflation, is a necessary condition for financial sector development and efficient intermediation, which in turn can accelerate economic growth. Indeed, inflation influences economic growth primarily through affecting financial sector development.

4 — 4 The Banking Market: Small and Dominated By State-Owned Banks

(1) At year end 1999, the banking system in Lao PDR comprised (a) four state-owned banks including APB, (b) three joint-venture banks,[4] (c) seven branches of foreign banks, and (d) one representative office. These banks are commercial banks except for APB, a policy bank, primarily geared towards development banking for agricultural and rural development, but also performing commercial banking operations.

Table4 — 2 Market Share of Banking Institutions, December 1999

Type of Institution	**Number**	**Assets (US$ million)**	**Assets in % of Total**
State-Owned Banks	4	289	70.7*
Foreign Branches	7	85.5	20.9
Joint-Venture Banks	3	34.0	8.3
Representative Office	1	0	0
Total	15	408.4	100

*APB's assets account for about 5 percent of total assets in the banking system.

(2) The Lao banking sector is small in absolute terms, with total assets in the system amounting to approximately US$ 408 million. But small size is not a curiosum applying to a handful of countries. Many financial systems are extremely small: about 60 countries have financial systems each of whose total size (measured in terms of M2) is less than US$ one billion, no larger than a small bank in an industrial country.

(3) Furthermore, the Lao banking sector is also relatively small when compared to the size of Lao economy: the ratio of total assets of the banking system to GDP is about one third. This is particularly low for an economy with a non-diversified financial system (i.e., with no alternative but banks for the supply of loans) and it evidences a system in its early stage of development. This ratio can be compared with a ratio of 80% in Thailand where the financial sector is much more diversified.

(4) State-owned commercial banks dominate the market with more than two-thirds of the

4) The Lao-Viet Bank, the joint venture bank invested by the BCEL and the Bank for Investment and Development Bank of Viet Nam, was opened on June 22, 1999.

total assets. The three largest banks (BCEL bank, Lao May bank, Lane Xang bank) are fully owned by the Government; BCEL maintains a dominant position accounting for approximately half of total deposits, and almost 40 % of total loans in the system. For a financial analysis of BCEL and APB.

Table 4 — 3 Banking Sector Development: International Comparison

Country	Domestic credit provided by the banking sector/GDP (%) (1997)	Share of state-owned banks in total bank assets (%) (1996)	Credit to SOEs /total domestic credit (1996)
Vietnam	23	80	57
Indonesia	58	48	3
Malaysia	165	8	-
Korea, Rep.	86	13	1
Thailand	140	7	3
Philippines	85	-	1
China	106	82	82
Russian Fed.	26	-	14
Poland	37	-	18
Lao PDR	11	66 *	40**

*Share of total assets of the four SOCBs in total bank assets, and credit to SOEs extended by four SOCBs as a share of their total credit, December 1998. (Source: World Bank, BIS, and staff estimates.).
**1999.

(5) The Lao banking system is characterized by a marked geographical concentration in banking service in Vientiane and large cities. This concentration is likely to increase. The ongoing bank restructuring program consolidated six national and regional state banks into two state-owned banks of comparable size, Lao May Bank and Lane Xang Bank.[5] The rationale for the mergers includes cost savings and the closure of unsustainable branches. The mergers would make it easier to improve management and make better use of scarce managerial and banking skills in the country.

(6) Foreign banks are not allowed to establish and operate outside the capital city.

5) Lao May Bank Ltd. is the result of the "southern" merger of the old Lao May Bank, Phak Thai Bank and Nakhoneluang Bank, while Lane Xang Bank Ltd. is the result of the merger of the "northern" old Lane Xang Bank, Aroun May Bank and Settathirath Bank.

Among foreign banks, Thai banks dominate as six out of seven foreign bank branches are Thai bank branches. This concentration makes Lao PDR more vulnerable to shocks to the Thai economy and may limit transfer of banking expertise.

4－5 Non-Bank Financial Institutions

(1) There are few non-bank financial institutions (NBFI) in Lao PDR, evidencing a narrow, i.e., undiversified financial system where there is still limited alternative to banks for access to financial services. The microfinance system is starting to emerge; there is only one insurance company; and the Social Security system is still in its infancy with little or no accumulated financial surpluses.

(2) Institutions such as leasing companies which base their lending on future cash flow of a rented asset, rather than on past performance and collateral are missing. Life insurance institutions providing long term capital are also lacking. There is no capital market or arrangements providing equity or debt or standardized debt contracts.

4－6 Microfinance

(1) Microfinance, i.e., the provision of financial services to poor people (in rural or urban areas) through specialized sustainable institutions, is an important opportunity in a country such as Lao PDR where the majority of the people does not have access to formal financial services: 80 % of the population lives in rural areas and 90 % of that population do not have access to formal banking services. Furthermore, it has been demonstrated that microfinance is an effective tool to fight poverty and Lao PDR is a poor country with GDP per capita standing at around US$ 400/year. But in Lao PDR, the microfinance industry has only started to develop in the last four years and is still limited compared to other similar countries such as Cambodia, Nepal and Viet Nam. But if the Lao microfinance industry integrate lessons learnt and best practices, benefits from a stable environment and an improved formal financial sector, it could contribute significantly to reducing poverty.

(2) Despite a large potential market for such services and in particular for savings services (only 1 % of the rural population have access to deposit services), the supply of such services is low. Besides APB-the Government owned policy bank-and informal

lenders, there are still very few potentially sustainable microfinance institutions (MFIs) in urban or rural areas: less than ten MFIs with less than 2,000 customers each. The recent development of MFIs through a Government executed project is however already showing that it is possible to implement microfinance with a focus on poor women, sustainable interest rate and repayments exceeding 99 %. The project is currently exploring the opportunities for institutionalization and expansion of these emerging MFIs.

(3) Lao PDR presents many challenges that explain why microfinance is difficult to implement. The outreach of each MFI is limited due to the low density of population; this results in higher unit transaction costs making it more difficult to become sustainable. The local infrastructure, mainly roads, are in bad conditions which render access to villages difficult and increase transaction costs further, especially during the rainy season. The capacity is low and it takes significant resources to train candidates to manage MFIs. There are few local institutions which can be built up, since most cooperatives have been unsuccessful in the early nineties and the MFIs built before the "liberation" have disappeared.

(4) But the present limited development of microfinance in Lao PDR results also from the fact that policy makers still need to be sensitized about the advantages of Microfinance and have created a somewhat difficult policy and regulatory environment although it is not vigorously implemented. The existing regulation on credit cooperative does not leave much space for different models to emerge. Regulation 02/SB from BOL dated November 19, 1994 regulates credit cooperatives. This text is quite thorough and applies to sophisticated institutions. So its not surprising that only two institution has registered under this regulation. Through its Microfinance project, the Government is currently reviewing the constraints of regulating and opportunities for improving the regulatory framework. The nascent microfinance sector also competes with subsidized credit. The Government has created an uneven playing field in the micro-lending business making it even more difficult for sustainable MFIs to emerge. APB is sometime lending at very low (subsidized) interest rates incompatible with cost recovery and sustainability. It is funded mainly by BOL and other SOCBs. Finally, donors in Lao PDR are also responsible because they have limited experience and knowledge in microfinance best practices but promote and continue to fund projects which often cannot become sustainable. How-

ever, recently, the Government has organized a Workshop on Microfinance and positive recommendations were formulated such as "taking step by step approach on regulation matter."

(5) From the survey conducted by the UNDP/UNCDF in 1996, it was estimated that informal financial institutions (mostly in the form of donor funded revolving funds) reach about 15 % of villages. The survey also showed that, before 1996, about 8 % of households had borrowed to buy fixed assets, and about 13 % had borrowed for working capital.

4－7 Non-Life and Life Insurance Industry

(1) This is a one-company industry. Prices and indemnities are controlled. Technical reserves are invested in term deposits only.

(2) The insurance industry is regulated by the 1990 Insurance Law (11/90) which was inspired by the French insurance law and an implementing decree (No. 1/PM) dated January 23, 1992. The Ministry of Finance with a staff of two, is in charge of supervising the industry and getting the prudential rules implemented.

(3) Assurances Générales du Lao (AGL) was established 1991 and is the only Lao incorporated insurance company. AGL is a joint venture between State of Lao (49 %) and Assurances Générales de France (51 %). It benefited from an initial 3 year official monopoly. Today AGL remains the only insurance company. AGL's non-life insurance accounts for 90 % of its business and car insurance accounts for 40 % of collected premiums. With recent high inflation rates, amounts have become almost meaningless as they are not revised.

(4) Total premiums collected amounted to 11 billion kip (US$ 2.5 million) in 1998. AGL posted a 15 % operational profit. However, its net result of 60 % of sales in Kip was due essentially to capital gain on equity kept in dollar. AGL paid taxes on the net profit hence depleting its capital base. Technical reserves are entirely deposited in domestic banks (BCEL essentially) and abroad in up to one-year term deposits in Kip and other currencies. AGL has decided not to invest any part of its technical reserves in real es-

tate in Vientiane.

4－8 Social Security in Lao PDR

(1) The impact of the social security system on the financial sector is negligible and may remain so in the coming years. The system is currently being in part reformed and in part redesigned. It is likely that no significant financial surpluses will be accumulated.

(2) For the public sector, social security and pay-as-you-go pension systems were introduced a few years ago. Since December 1989, all civil servants are required to contribute 6 % of their salary to the "Social Security Fund" which provides comprehensive protection including pension, child allowance, invalidity from war, medical care, death, maternity and sickness. This Fund is managed by the Social Security Department, Ministry of Labor and Social Welfare (MLSW). The Government provides annual budgetary support to supplement the employees' contributions as needed to meet expenditures. In the first nine months of FY1999, the Government paid about 16 billion kip to support the Fund. In the past two years, about 70 % of the Fund expenditures came from the Government. The system will be reformed in the near future as it is government's intention to establish a funded pension scheme and separate it from the social security fund.

(3) For workers in state-owned enterprises and private sector companies with ten or more workers, a social security system has been implemented gradually on compulsory basis since mid-2000. Smaller companies can voluntarily join the system. The system will provide health care and disability benefits, and pensions. The system should be self-financing. Contributions will be 9 % of total earnings of the worker, shared by the employer and employee. The Social Security Organization (SSO), an autonomous institution under the MLSW, manages four separate funds, one for each type of benefit: health care, pension, injury and disability and short-term benefits.

4－9 The Leasing Industry in Lao PDR

(1) Leasing is a tool well adapted to the needs of new, small and medium-sized enterprises with no financial history: leasing decision are made based on future cash-flows generated by the leased asset rather than historical performance of the borrower. Furthermore, it is also adapted to countries where the judicial system is weak as repossessing

an asset because of non payment is generally easier.

(2) In February 1999, the Government issued a Leasing decree (No. 11/PM) which provides the legal framework for the development of financial leasing in Lao PDR. The decree requires that a finance lease company be licensed by the Bank of Lao PDR (BOL). Licensing conditions are (a) to be a juridical entity; (b) to have entered in at least six duly registered written leasing agreements in a year; (c) to have a minimum registered capital of 500 million kip; and (d) to have a sound financial condition and staff with skills in leasing activities and business experience. These normal requirements restrict the qualified applicants to foreign leasing companies, and joint venture companies with foreign partners engaged in leasing. This is not necessarily a negative feature as there is currently no local capacity.

(3) The Leasing decree states that finance lease companies are to be supervised and regulated by the BOL but prudential norms have yet to be established. Submission of audited annual reports to BOL is required, and accounting must follow the enterprise accounting law. The basic regulatory framework for leasing must recognize that it is a distinct form of financing and ensure that it is equal treatment to other types of credit. An area that may need more investigation is the tax law applicable: tax laws must clearly define the tax obligation and tax credits (including depreciation) that the parties to a lease expect to incur. This allows a potential lessee to evaluate the cost of a lease compared to other sources of equipment finance.

(4) Funding adequately the leasing activity will not be easy in Lao PDR. Medium-term funds are scarce and until the Lao financial sector develops it is likely that finance lease companies will have to mobilize offshore funds. Raising funds through issuance of financial instruments such as promissory notes domestically or raising funds offshore, requires BOL approval. In addition, raising funds offshore will require approval by the Foreign Investment Management Committee under the Office of the Prime Minister.

(5) Yet presently, one year and a half after the Leasing decree was promulgated, no one in Lao PDR is involved in leasing operations. It appears that the main reason is a lack of understanding of the advantages of leasing. Except for executives of the foreign bank

branches that have affiliates at home engaged in leasing, domestic bankers know little about financial leasing and none of the banks have expressed interest to develop a leasing business.

(6) Reflecting the sector's potential, leasing volume has been growing rapidly in developing countries, where new leasing contracts covering US$ 44 billion-worth of assets were signed in 1994 (accounting for 11 % of the financing costs of capital equipment), up from US$ 15 billion in 1988. (Source BIS).

5. Banking Reform: Situation Analysis, Strategies and Policies

Khamphout Sitthilath

In aspiring to graduate from the least developed country status by 2020 and maintaining macroeconomic stability, Lao PDR is embarking on a major program for banking sector reform and development. This paper provides perspectives on the diagnostics of the sector, the strategic framework that straddles relevant Lao elements and the goals of the international financial community, and the strategic policies needed to bring the framework to fruition.

5－1 Situation Analysis

The Lao PDR financial system is narrow and small. The total system's resources are in the order of US$ 400 million. A total of 15 commercial banking institutions dominate the sector, with four state-owned commercial banks (SCBs) accounting for about slightly more than two-thirds of total banking assets, seven branches of foreign banks for one fifth, three joint venture banks for about one tenth and one representative office for nil. Non-bank financial institutions constitute an insignificant part of the system.

As Lao PDR, with a centralized governmental structure, gradually moves toward a market-based economy, early-stage economic management has provided challenges on investment efficiency. Fiscal deficits have been funded by capital inflows. The Government is striving to significantly expand its revenue base and has reversed the past practice of resorting to central bank financing. The 1997-1999 inflationary pressures and currency adjustments caused deterioration in the quality of bank credits and attrition in the capital accounts of the banking system, especially among the SCBs. The recent restoration of fiscal balance and tight monetary management has tamed inflation and introduced a modicum of currency stability.

Underlying the portfolio problems of the SCBs are deep-seated institutional areas of concern in their bank-wide governance. Non-commercial lending has been a proximate source of non-performing loans (NPLs). At the same time, weaknesses in credit risk management and an incipient enterprise sector have tended to strain the quality of credit accounts. Banking skills in this transition economy are still in their earliest formative stage. There is a continuing program to enhance SCB governance oversight, structures, policies, systems, procedures, transparency and accountability. The Authorities have mandated the restructuring of SCBs with the aim in view of transforming them into sound, sustainable and accountable institutions that would not constitute a moral hazard and pose a serious threat on fiscal resources.

The country's accounting and auditing profession is still evolving. While there is an existing Accounting Law, there are no national accounting standards. That said, the Bank of Lao PDR (BOL) has introduced a Chart of Bank Accounts whose categories provide reasonable disclosures that would facilitate a meaningful reading of financial statements. While there are bankruptcy and collateral laws, the judicial system for loan recovery is weak. BOL supervision activities are in the developmental stage, with technical assistance funded by multilateral sources.

Table 5 — 1 SWOT Analysis of the Combined Operations and Position of SCBs

Strengths	Weaknesses
➢ Openness of management to new policies, methods and systems ➢ Fairly established deposit mobilization capacity ➢ Established funding position ➢ BCEL: dominant position in forex business	➢ Need for capable and commercially experienced management ➢ Need to strengthen governance, governance structures and staffs ➢ Need to restructure bankwide policies, systems and procedures ➢ Need to develop institutional autonomy ➢ Need to improve asset quality ➢ Need to improve margins on deposits ➢ Need to rationalize costs and staffing ➢ Need to build up capital levels
Opportunities	**Threats**
➢ Challenge of improving credit management further to strengthen balance sheet and profitability ➢ Challenge of branch & staff rationalization to reduce operating expenses ➢ Potential for internal reengineering to reduce cost coefficients ➢ Potential for growing forex business & fee-based income ➢ Potential for effective judicial system on loan recovery	➢ Possible non-commercial lending ➢ Vulnerability to systemic disturbances ➢ Erosion of market shares

5 — 2 Strategies

In January 2001, Lao authorities, in active collaboration with the international financial community, held a High Level Policy Workshop to assess the "Whats" and "Whys" of banking reform. As a result of that successful Workshop, Lao authorities have formulated a strategic framework for the development of the country's financial sector. The first order of business was to define the all inclusive Vision Statement.

(1) Vision Statement.

The Vision Statement sets forth that:

The financial sector will be supportive of broad-based sustainable economic growth and reduction of poverty. The financial sector will help enable the Government to achieve its goal of graduating from the least developed country status by 2020. The financial system will have the depth needed for economic growth and development and will contribute to macroeconomic stability.

The financial system will provide wide access to financial services and extensive market reach. It will efficiently perform the functions required by the Lao economy, that is, to:

- mobilize savings from the people and enterprises;
- allocate the country's resources to the most productive investments and income generating activities;
- provide secure and rapid payment services;
- ensure financial and credit discipline on customers, and
- reduce and transfer financial risks.

The financial sector will be diversified with sustainable banks and non-bank institutions.

(2) The Banking Sector.

For the sub-set of the banking sector, Lao authorities have asserted that:

The area of greatest urgency is the banking sector. Banks will be modern, sound, robust, efficient and sustainable. They will be cost efficient to deliver services competitively and they will be customer oriented to deliver desired services. Banks will be comparable with banks in other ASEAN countries and have international linkages for enhancing their competitiveness.

(3) Key Critical Factors in Banking:

If the vision for the banking sector is to become a reality, the sector must show a set of key characteristics.

- Banks' business decisions will be independent and driven by the market mechanism.
- No policy or other non-commercial lending will be financed by the deposits from the

public.

- The boards and management of banks will be responsible and accountable for their business decisions.
- Banks will impose proper credit and financial disciplines on borrowers.
- Management and staff will have skills that meet international standards.
- A supportive enabling environment will exist:
  - accounting: to ensure quality of financial data;
  - legal and judicial: to ensure enforcement of contracts;
  - regulatory: to ensure proper supervision; and
  - fiscal and monetary: to ensure stable macroeconomic conditions.
- The system will allow entry of institutions with diverse profiles.

(4) Commercial Lending.

Lao authorities have asserted that SCBs should operate on a commercial basis. This means: (a) lending only to creditworthy borrowers, whether SOE or private, i.e., do not lend to defaulters and observe minimum credit quality for loan approvals; (b) branches should make money and steps taken to phase out or scale down unprofitable ones; (c) investments should make money, i.e., returns should be attractive and related to risks taken; and (d) every bank should make money and steps taken to rationalize costs, including staffing. SCB crises arise from NPLs that result from poor management, weak credit practices and loans for the wrong purposes. Lao authorities view policy lending as necessary, but should be analyzed on a commercial basis. While policy lending should focus on poverty reduction, there is a need to consider SCB efficiency and profitability.

(5) Enabling Environment.

Lao authorities are taking steps to improve the enabling environment for banking. The menu of potential interventions include: allowing SCBs flexibility in their asset/liability management, weaning them away from the residual influence of mono banking under the old centralized planning era; providing tax guidelines that allow the deductibility of required provisions, thereby encouraging prudential behavior relating to adequate provisions; activation of a proactive Bankers Association that would promote the orderly adoption of sector-wide best practice banking methods; the establishment of a well-equipped Banking Institute to upgrade banking skills; the development of the local accounting profession; legal and judicial improvements to hasten SME development and facilitate loan recoveries; strengthening banking regulations and supervision to ensure a sound banking system, striving toward the Basle core principles; reform of state-owned enterprises (SOEs); and deepening of the enterprise sector.

(6) Operational and Financial Restructuring.

SCB restructuring entails both operational and financial restructuring. The SCB Restructuring Plans would address the three broad sets of issues: (i) the priorities/management, (ii) people and capacity building, and (iii) systems, procedures and processes. SCBs would assess their "core business" and future strategies. Based on the bank-wide assessment, SCBs would analyze: the appropriateness of the existing structures and define their proposed structures; the manner in which the Bank currently conducts its business and the efficient way to do it, specifying the basic principles and policies; the application of the approaches above to all the structural units; and the economics of the operations of branches, service units and exchange units, and a determination of their closure, downsizing, spin off, sale and combinations. SCBs would define the parameters for staff rationalization, and develop the program/scope for retraining, re-employment in other activities, retirement or redundancies. MOF and the Bank's Board would define the social safety net (relating to the consequences of rightsizing, re-engineering and introduction of new bank technology). SCBs are considering two general options in setting up an efficient bank technology system: migrate the present system into a more efficient one; or set up an entirely new system and infrastructure and train the personnel in applying them.

The SCB financial restructuring and capital build-up program would include: (a) phased government bond injection by the shareholder, based on a time-frozen benchmark for old stock NPLs and subject to the condition that the SCBs meet the agreed performance targets and overall performance grade, to Old Stock NPLs, with the programmed government bond injection being deferred to a time when the Bank could meet the period-specific performance targets and overall performance grade; (b) NPL recovery / individual asset restructuring which would improve the capital position; (c) increase in retained earnings; (d) disposal of non-essential fixed assets that improve the capital position; (e) equity subscription by "fit and proper" investors other than government entities.

(7) NPL Resolution.

The objectives of the resolution of NPLs include: instilling credit discipline; undertaking the operational and financial restructuring of potentially-viable borrowers; reducing overall fiscal costs to Government; building capacity within the Bank to handle "normal" NPL collections and recovery; and building capacity in the legal/judicial system to handle contract disputes. The NPL resolution process would be: initiated and led by SCBs; well-documented; fair; carried out on a case-to-case basis; with full disclosures to all concerned parties; and implemented under a well-defined decision making process that strictly adheres to objective criteria.

(8) Qualitative Performance Indicators.

SCBs would adopt Restructuring Plans that include: a bankwide reorganization plan; policies and procedures relating to strategic and financial planning; risk management; branch banking; international services; operations; accounting, auditing & control; human resource management; MIS/IT; and performance management & reward system; an institution building program covering areas above; cost cutting measures including, as a minimum: closing, merging, downgrading (to service units) & spinning off unprofitable branches; downsizing the personnel complement through a "social safety net"; selling unproductive & redundant assets; and other necessary measures to be defined. SCBs should satisfactorily implement the above plans, policies (especially credit approval limits), procedures and institution building programs, and the Interim Measures adopted to strengthen the improvement regime.

There will be an overall weighted rating for the Performance Indicators. The trigger for capital build-up presupposes that the SCBs receive a overall rating of S"(Satisfactory), not "U" (Unsatisfactory)

(9) Quantitative Performance Indicators.

SCBs would have time-bound targets and corresponding ratings for these Quantitative Performance Indicators:

- ***C***apital Adequacy: capital adequacy ratio
- ***A***sset Quality: NPL ratio; % recovery of "Old Stock NPLs"
- ***M***anagement Efficiency: operating expense ratio; net interest income to total income ratio

- **E**arnings: return on assets
- **L**iquidity: liquidity cover for deposits
- **S**ensitivity: gap ratio; forex exposure ratio

There will be an overall weighted rating for the above Indicators. The trigger for capital build-up would require meeting at least the time-bound overall weighted rating.

(10) Organizational Support and Oversight.

The Authorities are in the process of defining the appropriate formula for mobilizing international expertise in SCB restructuring. The arrangement would be such that it would adequately address local conditions to ensure the full attainment of Restructuring Plans. But the Authorities have already defined the oversight mechanisms needed to track SCB performance vis-á-vis the Restructuring Plans. A Banking Division will have responsibilities that include: monitoring the implementation progress and issues of the MoUR and the Bank's Restructuring Plan, and to that end, undertaking an assessment of the Bank's operational and financial performance and condition; formulating recommendations to the Bank's management, MOF and BOL on modes for resolving implementation issues; independently formulating the Performance Grade of the Bank based on meeting targets for Performance Indicators as a basis for determining eligibility to obtain the Government recapitalization instruments and, accordingly, assessing the performance of the Bank's Board and top/senior management; drawing up the Terms of Reference for the IAS and interim audits of the Bank and liaising with the international auditors in the conduct of the audits; coordinating with BOL's Banks and Financial Institutions Supervision Department (BFSD) on the implementation of the Interim Measures and other BOL regulations/directives; advising all parties to the MoUR on important developments affecting the MoUR and the implementation of the Restructuring Plan; interfacing with International Financial Institutions, as appropriate, on relevant issues of concern; assisting the MOF in screening and recommending candidates for the Bank's Board and top/senior management; and undertaking whatever tasks might be necessary in helping ensure the faithful compliance of the MoUR and the successful implementation of the Bank's Restructuring Plan.

The regulatory authorities will also have a role in monitoring performance. BOL will take steps to strengthen BFSD and, in pursuit of that objective: BFSD will strive to eventually fully operate in conformity with the BIS core principles on Bank supervision; BOL will formulate and implement a program to upgrade the regulatory framework, staff skills (including knowledge of banking practices and instruments), systems and hardware within BFSD; BFSD will ensure that the Bank, as all banks, is either strictly complying with key BOL regulations, especially those relating to non-accruals of interest income on NPLs and adequate provisions, or with the forbearance regime; BOL will take steps to encourage the formation and regular functioning of a Compliance Committee within the Bank to ensure regulatory/forbearance compliance, accurate reporting and effective resolution of regulatory exceptions. The Managing Director would chair the Compliance Committee. Strengthened bank supervision off-site and on-site activities would apply applicable penalties on regulatory infractions, with the objective of reinforcing compliance culture.

5－3　Policies

(1) Strategic Policy Statement.

The strategic policy of the Lao PDR banking reform is to reduce the weakness of unhealthy parts and increase the growth of healthy components of the system, while creating an enabling environment that supports the ability of banks to function on a sustainable basis.

(2) Downstream Banking Reform Policies.

While Lao authorities consider policy lending as necessary, they assert that: all Bank lending, should be subject to commercial credit appraisal criteria; directed and other forms of non-commercial lending will not take place in the Bank; management will be accountable to implement these two principles; implementing and monitoring these commitments will occur through: (a) SCB actions including: an irrevocable Board resolution clearly enunciating the above principles; minutes of Board and Management committees referring to policy lending; management and staff workshops on commercial lending and policy lending; and SCB reports to BOL concerning policy lending; and (b) BOL actions: a directive to banks on reporting concerning policy lending and non-commercial activities; and periodic inspection and reports.

SCBs will price loans and deposits according to profitability and risk considerations without external influence. The implementation and monitoring arrangements include:

SCBs' Board resolution approving Bank asset/management policy, including pricing principles and guidelines; minutes of meetings of Head Office Credit Committee and Asset-Liability Management Committee (ALCO) setting interest rates on loans and deposits; and intermediation Cost or Spread (among the Financial Model Performance Indicators).

6. Current Situation of Financial Sector and Its Problem in the Lao PDR

Hisatsugu Furukawa

6－1 Financial Environment of Laos

(1) Overview on Financial Environment

1) Current financial situation

Lao government once succeeded to contain inflation and sharp depreciation of Kip in 2000, by applying decisive tight money policy in the latter half of 1999. But, outstanding loan amount of domestic banks have been increasing recently and risk of emerge of new NPL (Non Performing Loan) and rebirth of inflationary pressure seems to be increasing again (Table 6－1). Banks are lending in Kip using foreign currency based funding. This means that banks are creating miss match of portfolio, between funding and lending, and increasing solvency risk. Once currency fluctuation occurred, banks might face not only foreign currency exchange loss but also foreign currency liquidity shortage, if depositors would rush to withdraw foreign currency deposits in fear of some restrictive measures for foreign currency exchange to be taken.

Table 6－1 Loan outstanding of financial institutions
(end of the period: annual increase rate from previous year, %)

	12/1999	6/2000	12	6/2001	12
Commercial bank total	+58.6	－7.2	+43.5	+43.8	+45.3
o/w Thai banks	+14.7	－37.5	+16.0	+3.1	+3.6
Inflation rate (CPI: annual increase rate)	+86.7	+21.4	+10.0	+6.7	+7.5
Kip/US$ rate	7674	7778	8238	8594	9467

(Note) sources: B/S data of financial institutions & Kip/US$ rate by the BOL, inflation rate by NSC, the same hereafter. Kip/US$ rate is middle rate of selling-buying with customers by commercial banks.

Foreign currency deposit consists about 64% of funding, whereas share of foreign currency loan is less than 40%. Loan/deposit ratio is also low (about 60%, cf. Table 6 — 2) and the balance is held as the reserve money at BOL (about 5-6% seems to be the excess reserve, because the reserve requirement ratio of BOL imposed on banks is 12% of deposit in Kip and balance of foreign currency with a term of less than one year) and as deposits in overseas financial institutions through correspondent account (about 17%, as Nostro account, which includes necessary deposit to settle imports, cf. Table 6 —3).

The tentative money flow chart (Figure 6 — 1) made from available balance sheet data of Lao banks, supplemented with the Balance of Payments and the central government annual budget data, shows that the Government sector plays an important role as funding channel of economic activity in the Lao PDR. While it cover the shortage of domestic funds by receiving financial assistances from abroad, including loans of goods, funds flow back to abroad via private non-financial sector (settlement of import) and financial sector (as deposits to correspondent banks abroad).

Table 6 — 2 Changes of loan/deposit ratio (%)

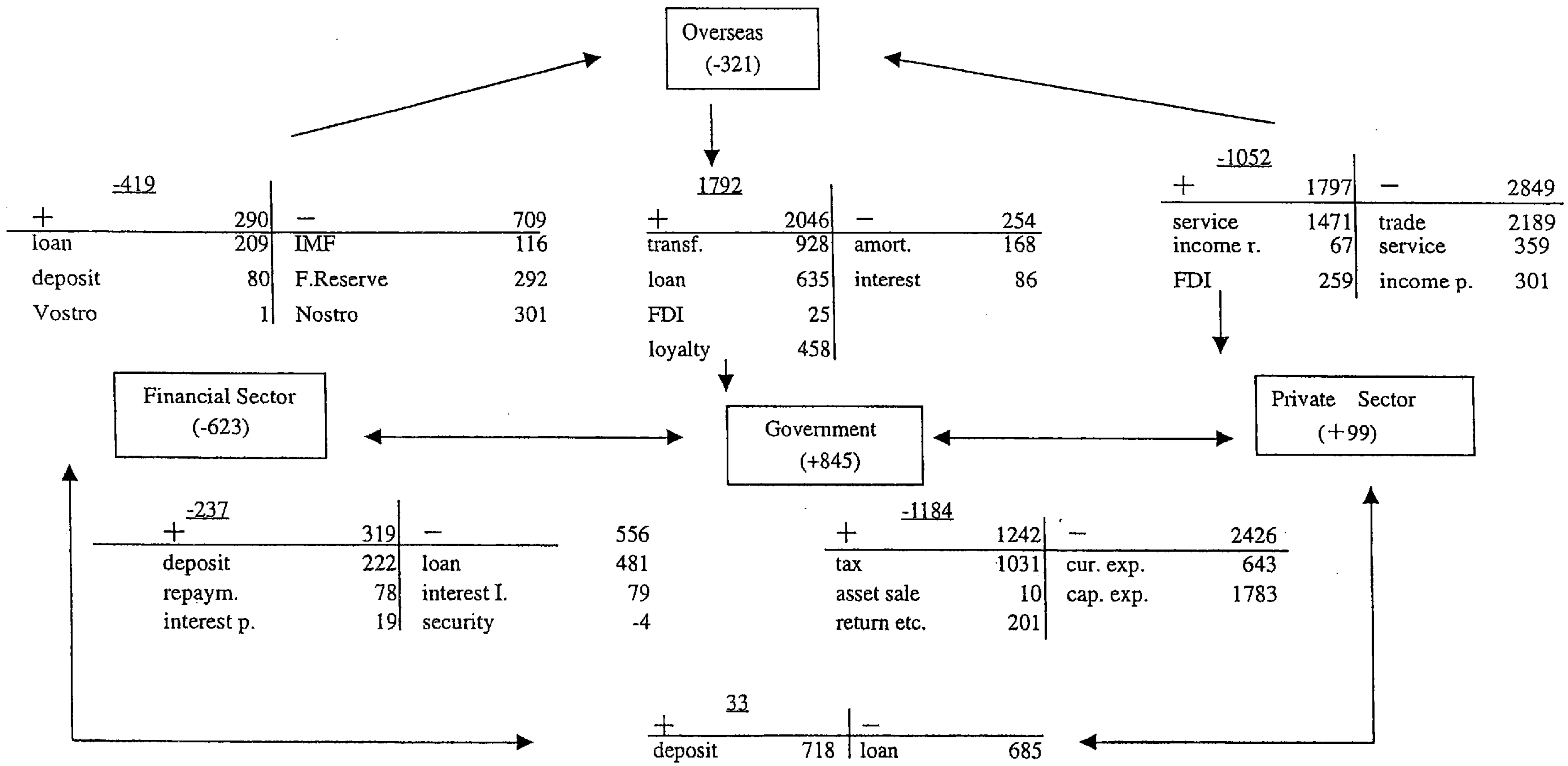
	12/1999	6/2000	12	6/2001	12
Commercial banks total	51.6	49.1	55.5	61.8	61.4
o/w Thai banks	90.0	80.0	81.4	78.6	73.6
o/w J/V banks	94.2	79.1	77.6	77.2	72.7

(Note) inter-bank deposits are excluded

Table 6 — 3 Fund raising situation of banking sector

(As of end 2001<estimate>, shares for total fund raising amount %)

Fund operation		Fund raising	
BOL deposit	16.7	Borrowing	9.4
Loan	49.2	Deposit	80.1
(o/w in foreign currency)	(36.6)	(o/w in foreign currency	(64.3)
Nostro a/c	17.1	(o/w non-residents and international organizations)	(9.0)
Inter-bank deposit (domestic)	5.4	Vostro a/c	0.6
		Inter-bank borrowing	5.5



(Note) This chart was made from Balance sheet data of banks in Lao, Balance of payment data by BOL and Central Government budget data by the Ministry of Finance. Author estimates some of the breakdowns by sectors. Capital investment to Cooperates (SOE and private companies), inter-company credits are not included because of limited availability of data.

Figure 6 − 1 Money Flow in 2000 (billion kip)

The increase of bank loan/deposit ratio, as well as money supply since the middle of 2000, reflects the expansion of domestic loans, not a few part of which may be attributed to the decentralization of budget management since last year, because increase of bank loans may coincide with increase of autonomy of budget execution in provinces and the temporary shortage of tax revenue. If delays in payment by the Government or related agencies should happen, it might cause new NPL problems.

Table 6 — 4 Annual increase rate of Money Supply (M2, %)

12/1999	6/2000	12	6/2001	12
+78.4	+7.9	+45.8	+17.9	+32.6

2) Savings mobilization

In remote area, people still barter goods, and financial deepening is still in its early stage (Refer to Ch.4 prepared by Mr. Khamphout Sitthilath). Branch networks of financial institutions are not yet well developed and their services are limited. As the services by financial institutions have not yet been spread across the country, domestic savings ratio (6.2% on GDP basis of 1997) is low. It appears, however, that the necessity of savings is beginning to be understood by people in general. Demand for funds among people is strong and mutual loan associations or mutual financing associations are widely used both in cities and the countries. It is said that micro-financing activities supported by UNDP, Women's Union, NGOs etc. have been steadily expanding. There are some groups in local areas that have been increasing their funds through production of handicraft, without receiving any monetary support from others.

According to the Household Survey conducted by NERI/NSC (as of May 2001) as part of the MAPS project, almost all the families surveyed answered that "saving is necessary," and the share of families who have savings accounts for 90 % in the city areas (in the rural areas they account for 60-70 %, and they account for 76 % if all the families surveyed are included). The main motivation for savings is to buy animals and precious metals (about 40 % and about 30 % respectively in the share of all respondents)(*). On the other hands, the families who have saving accounts at banks account only for 10 %.

As a matter of fact, many families have production surplus in the form of precious metals and livestock such as buffalos and cows (according to a UNDP/UNCDF survey published in July, 1997 on micro-financing, livestock account for more than 70 % of total saving amounts) and when we take these facts into account, we believe that actual savings ratio is much higher. Judging from the examples of other nations whose income levels are nearly the same as that of Laos, the United Nations, the World Bank and the like estimate that the domestic savings ratio in Laos is about 15 % (Table 6 — 5). Also, according to the Household survey (LECS 2 77/78) conducted by NSC, the savings ratio is 7.3 % (on GDP basis). Based on the recent survey by NERI/NSC mentioned above, if we consider fund for buying livestock etc. as a kind of saving, gross savings ratio (including bank deposit, money for buying precious metals and animals for rearing) out of all income of the families surveyed can be estimated as high as 16-17 % (if only a half of the fund is considered to be a saving, the savings ratio is about 12 %). The samples of the survey are limited and further surveys will be required. But this indicates that there will be much room for financial sector to absorb the surplus of income from local people and that it is highly recommended for authority to deregulate current rigid branch policy.

(Note) * BOL established a Joint Venture Gold Company together with the Government and private sectors, taking into consideration people's inclination to buy gold. The company imports gold from abroad using the invested fund (capital) and sells it in the market in Kip, then repeats buying gold with that fund. By doing so it supplies gold steadily to the market, expands routes of buying gold for people and contributes to stabilization of gold dealings and the foreign exchange market dealing to some extent .

Table 6 — 5 Saving Rate

Tanzania	10.6 (1993; following are the same)
Bangladesh	7.52
Nigeria	20.4
Sri Lanka	16.19
The Philippines	15.22
India	21.45
Viet Nam	16.3 (1995; gross saving rate)
Laos	11.5 (1995; the same as the above)

(Note): sources: "Theory of Development Economic" (World Bank, World Data 1995) by Yonosuke Hara, "Marketization of Economy in Vietnam" by Shigeru Ishikawa and Yonosuke Hara, Toyo-Keizai Shinpo-sha, 1999

(2) Some factors which restrict activities of financial institutions

Transactions with banks are still concentrated on cities and specific industries (public works-related industries like construction, commerce, services etc.). Because foreign banks are not allowed to open branches in local area and SCB hesitate to take new risks by expanding loans as they have large volume of NPL, many companies have difficulties in getting bank loans. Majority of loans are on a short-term basis and costly. Because of low credibility of SCB in international financial market, it is a custom that domestic companies are required to put, in some cases, 100% guarantee deposit at the bank even for opening L/C (i.e. there is virtually no merit for using L/C). Settlements using bills have not yet been developed and opportunities for financial investment are very small in domestic market. Under such circumstances, banks cannot make effective use of their fund, nor they can provide customers with attractive financial goods.

Followings are constraints, which prevent banks to be more active in the Lao PDR.

1) Financial transaction tools have not yet been developed;

In Laos settlements are generally made in cash or on short-term inter-company credit (accounts payable or receivable; in some local areas they still barter goods) and bill transactions are not made except for in some cases of international trades. Even with international trades, asking advance payments from foreign buyers for purchasing materials and producing goods is more common. Generally speaking, as such transactions are costly and credit amount is limited, it does not help much to increase profit or to expand businesses.

Negotiable securities, which can be used as collaterals (government bonds, L/C and some bills issued for exports and imports settlements) are limited. Mortgages such as factories, houses, machines, goods in process and the like can be collaterals but inappropriate management of registration systems and legal proceedings harms reliability in usage of collaterals. It is difficult for companies to borrow money from banks against book credits or transaction deeds, because people, including local banks, are not familiar with such transactions. Reliable collateral and guarantee system for borrowings should be developed.

2) Lack of efficient legal procedures for conflict settlement;

It takes much time to settle conflicts and to handle dishonored bills. In addition, court often recommends compromise (exemption of interest payment etc.). Conflict settlements cost much. As a result, banks have difficulties in collecting overdue credits in due course and exercising rights legally secured.

3) Low capability of evaluation of borrowers' activity;

Basic capability of checking clients' balance sheet, business report and financial statements, analyzing profitability of the project, checking on the spot systematically and periodically borrower's collaterals are not yet prevailing. Companies do not disclose financial statements that satisfy needs of banks and financial analysts. This is because internationally acceptable accounting principles have not yet been set up. Most of the Lao companies have not executed revaluation for long and accountings based market price are not yet widely employed. They have not entered appropriate depreciation expenses for a long time. Therefore their balance sheets do not reflect actual situation of companies. Under such circumstances, it is difficult for banks to analyze the actual financial situations of applicants for loans.

4) Rigid branch policy;

Article 9 of Decree Law on Commercial Banks specified, "A branch and an office of representatives of foreign commercial bank may be established only in the capital of the Lao PDR". Because of such restricted branch policy, people in rural area have few opportunities to receive banking services. Micro-finance has been expanding steadily but it has not yet covered the whole country. They have not been united with nation wide banking network and this limit their funding capacity. A system in which people could get finance more easily both at national and local level has not yet been established; i.e. the mechanism of effective use of domestic funding resources (saving) is not yet exist in the Lao PDR.

5) Pressure of fiscal deficit and international trade imbalance;

Domestic demand for funds is strong because fiscal deficit has been lasting for long and private sector is, also, in need of finance for settlement of import and for making investments. But financial sector does not succeed in absorbing enough domestic savings and so Laos is depending most of the funds on foreign savings. Under such circumstances, economic growth of the Lao PDR depends upon foreign savings (i.e. foreign tax payers' will to what extent support the Lao PDR) and if government would increase investment without foreign finance, credit crunch will be happened and macro economic stability will be damaged by inflation.

6) Pressure of dollarization;

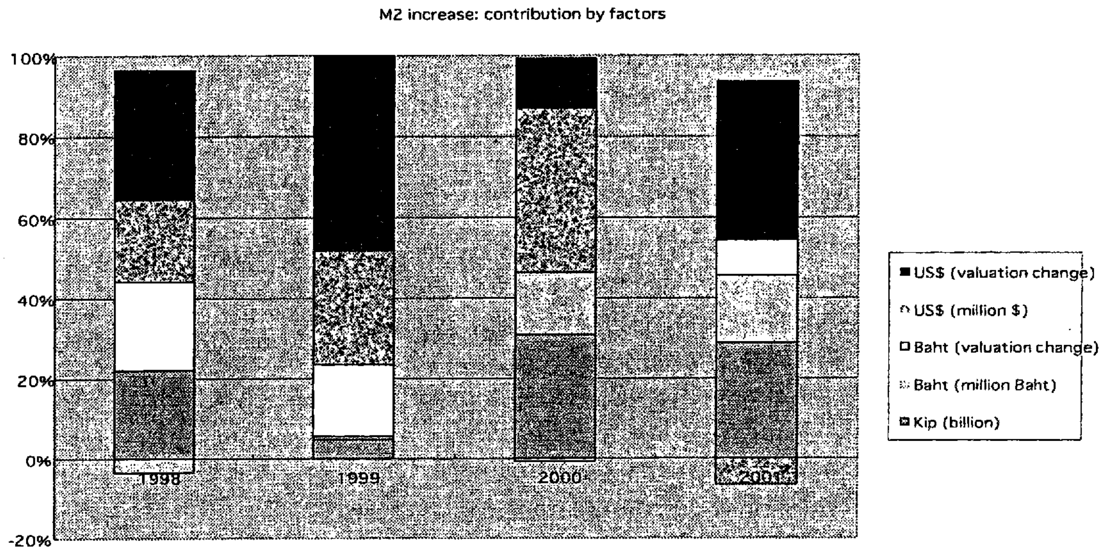
By law, only Kip is admitted as legal tender of Laos (Decree No.53) but, in fact, US Dollar and Thai Baht are widely in circulation. The share of foreign currencies in money supply (M2) has risen to around 70% at the end of 2000 from around 57% in 1997, due to depreciation of Kip. In particular, the share of US Dollar has risen to about 60% from 40% (Baht accounts for around 17%) and we can see that large shift of fund has been made mainly between US dollar and Kip due to fluctuation of market exchange rate (Table 6 — 5 and Figure 6 — 2). The change of foreign currency deposit balance happened almost in parallel with the change of the exchange rate between Baht and Kip until 1997, but since then, change of the Dollar exchange rate seemed to have bigger influence on the change of the balance than that of Baht (Figure 6 — 2). Netting the evaluation change accompanied by the fluctuation of the exchange rate, the main factor of M2 increase after 1998 attributed to the deposit in US Dollar, then to the deposit in Baht again in 2001 when the Kip exchange rate was stabilized, thus the fluctuation of exchange rates influenced on selection of currencies of depositors.

It is considered that transactions between companies or with large settlements amount are often made in foreign currencies, especially in US Dollar. According to a survey on border trades conducted by NERI (as of May, 2001), the share of currencies used in settlements for border trades is a little more than one-third for Baht, a little less than 30% for Kip, a little more than 10% for each of US Dollar and Chinese Yuan and a little less than 10% for Viet Nam Dong on average for those areas surveyed. Each

Table 6 — 6 Increase Rate of M2 and its Contribution

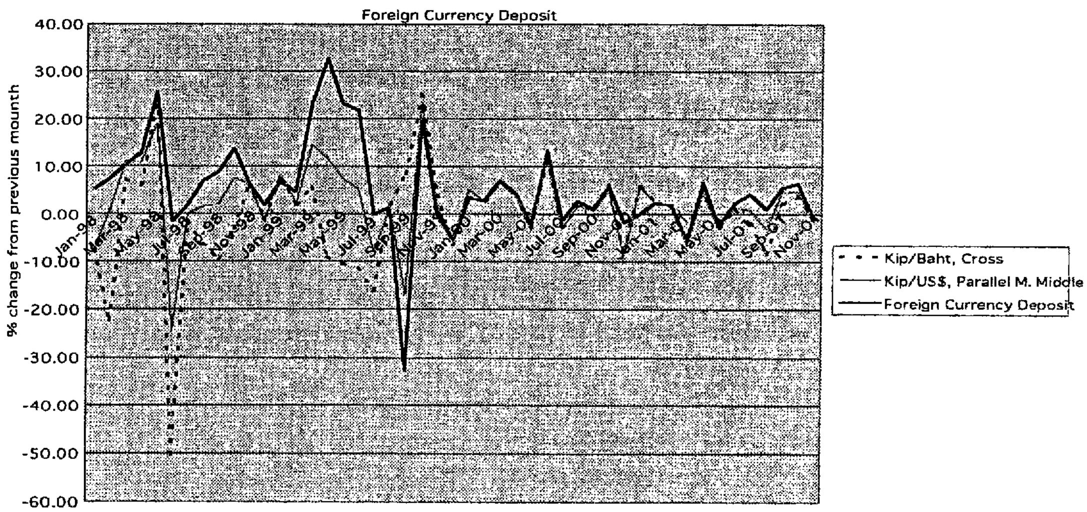
	Dec. 1998	Dec. 1999	Dec. 2000	Dec. 2001
M2 increase rate over the year before (%)	113.3	78.1	46.0	18.2
o/w Kip	61.9	11.2	70.0	25.2
o/w Baht	133.3	79.5	36.7	30.6
o/w US $	160.9	123.6	40.7	11.7
M2 annual increase amount (Over the end of year before; billion Kip)	460	679	710	411
Contribution to M2 increase (%)	100	100	100	100
In Kip	23.7	4.7	31.3	33.1
Deposit in Baht	-3.8	0.9	15.7	19.3
Evaluation change in Baht	23.8	17.9	-0.8	10.1
Deposit in US $	21.8	28.3	41.2	-7.5
Evaluation change in US$	34.5	48.1	12.6	45.0

(Note) calculated from data supplied by BOL.



(Note) Source: data from BOL

Figure 6 − 2 Contribution of M2 increase



(Note) For exchange rate, +indicates depreciation of Kip value, −indicates its appreciation Source: data from BOL

Figure 6 − 3 Foreign Currency Deposit amount

share of currencies used in the daily transactions including international trades for the areas surveyed is considered to be a little more than one-fourth on average for each of Dollar and Baht, a little more than 20% for Kip, 16% for Dong and about 5% for Yuan.

Banks can use deposits in foreign currencies as loans or inter-bank deposits. But Thai banks do not want to take too much credit risks from Laotian banks and, for that reason, tend to very much limit inter-bank transactions with Laotian banks and proposing relatively low deposit interest rates for inter-bank deposit in Baht (lower than the deposit interest rate that Laotian banks bear to depositors). For this reason Laotian banks tend to increase loan in Baht as much as possible. But this is risky from the prudential point of view. Deposit in Dollar, on the other hand, can be made on SIBOR or LIBOR basis through correspondent accounts and so, funding in Dollar does not cause so serious problem like funding in Baht. Backed with frequent use of foreign currencies, the parallel market (un official foreign currency market) is developed with fairly sophisticated and well functioning mechanism. The parallel market is supplementing the official market by giving opportunities to the people to preserve the value of their assets and to get necessary liquidity when they wish to buy expensive goods such as cars, houses and land.

(Note) In Laos because the dollarization (Thai Baht and US Dollar are widely used and Viet Nam Dong and Chinese Yuan are used in border areas with Viet Nam and China) has been under way, we cannot have exact information about how much cash is in circulation. If we assume that Marshallian K2 in Laos is the same level of Viet Nam in early 1990 (0.27), and calculate the amount of currencies in circulation from the GDP prompt data for year 2000, it is estimated that the dollarization ratio in Laos is about 70% of M2 (**). In this case we can calculate that the volume of foreign currencies now in circulation in Laos is about 2.3 times as large as M2 (***). If we presume that the dollarization ratio in Laos is 80 %, then the foreign currency volume in circulation will be a little smaller than three times of M2, equivalent to the scale in Cambodia according to Prof. Watanabe's calculation.

** Discussion paper prepared by Prof. Shinichi Watanabe, listed as reference materials at the end of this paper. It will be reasonable to consider that the Dollarization ratio in Laos is lower than that of Cambodia.

*** M2 ratio to GDP (Marshallian K2) is shown in Attached Table 6 — 7. The value of K2 is considered to be much lower than that of actual conditions, because there is much cash in circulation, which is not counted in the statistics, so I estimate that it is as high as 0.27, the same level as Viet Nam in 1990.

The equation of dollarization is as follows:

Dollar amount in circulation + deposit in foreign currency

$= \alpha$ (dollar in circulation + M2)

α is dollarization ratio (for Laos, including Dollar, Baht, Dong and Yuan)

Table 6 — 7 Marshallian K2

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001e
K2	9.5	7.2	7.1	9.1	13.2	15.0	13.2	14.2	18.5	20.4	15.0	16.7	17.9
K1	5.8	4.1	3.9	4.2	5.5	5.5	4.3	4.4	3.6	4.0	3.1	2.5	2.5

(Note) calculated from BOL annual report and additional documents, means estimation

7) Necessity of finance for development and long-term credit;

Most of public investment plan (PIP) of the Government depend on foreign savings and domestic funds are accounting for only about 13 % (2000-2003plan). When we look at the total amount of the Government general budget and capital expenditure, about 40% of the Government expenditure has been financed with foreign savings (1999-2000 closing account).

At the moment, Agriculture Promotion Bank (APB) finances development of local infrastructure centering on agriculture. But APB is in short of funding and is in over-loan balance. In addition, the share of short-term loan like half year or one year is high and the bank has not yet supplied enough middle and long-term funds (currently, middle and long-term finance is mainly for public investment-related project like government-sponsored irrigation facility maintenance project).

(3) Recommendations To Develop Financial Infrastructure

In order to improve current situation, authorities concerned are requested to ease the control on establishing new branches in local area, review collateral and guarantee systems, prepare variety of means of financial transactions by encouraging TB transactions, bill transactions, etc. and develop evaluation capability of banks on borrowers.

1) To prepare financial support measures for small-and-medium size companies and for export and import promotion, BOL should develop a bill re-discount system, an export bill re-financing system (ex. Some preferential buying scheme of textile export bills and bills issued to buy silk yarn), a foreign currency financing system for import settlement or a financing scheme for credit of buying coffee (as L/C and B/E <bill of exchange> transactions and packing credits exist, it may be feasible for BOL to finance them using these documents as securities). It will be possible for APB to issue bank debenture

and get necessary funds on middle-and-long term basis from commercial banks that undertake the debenture. Cooperative Type Financial Institutions and Credit Guarantee Systems should be developed to facilitate financing of small-and-medium size companies.

2) Lao authorities need to prepare laws and regulations on company accounting, credit security and guarantee, negotiable securities transactions and to implement them effectively. In this connection, closer cooperation with the legal system improving support project executed by JICA etc. will be required.

3) Improvement of accounting systems is one of the urgent issues; adopting valuation based on market price (asset revaluation of companies), promoting disclosure of companies and financial institutions and strengthening staff training including on-the-job training at banks in order to improve ability of evaluation of companies' management. In particular, it is vital to execute revaluation of assets of companies because it has not been done for ten years. During the period, Kip exchange rate depreciated very much and hyper-inflation occurred (during 1990 to 2001, consumer price index jumped by 13 times and value of Kip to US Dollar shrank to about 1/13). So many companies should have been suffering from shortage of capitals and reserves for depreciation. It is necessary for them, especially for SOE, to revalue assets as soon as possible, to dispose of NPL of banks, to recover appropriate capital ratio and to reestablish balance sheet.

4) Steps should be taken for revision of branch policy of banks and necessary re-location of them (in this connection, it will be necessary to revise the Article 9 of the Decree Law on Commercial Banks and allow foreign banks to open local branches independently or on a joint venture basis) and supporting postal savings network (postal savings started at the Central Postal Office in early 2001), expanding support for micro-finance activities and creating nation-wide fund mobilization scheme.

5) To facilitate budget management of government, Ministry of Finance should make more reliable forecast of government daily receipts and expenses. This will help monetary authority very much for establishing the demand/supply estimation in financial market, which is the prerequisite condition for conducting appropriate monetary operation in the market. If TB will be issued, based on that forecast more regularly with pre-announced schedule, it will facilitate government fund raising and may help lower fund raising costs. It will also help expand BOL monetary policy measures and offer better chances for saving mobilization.

6) Measures for wider use of Kip;

To stabilize Kip exchange rate, it is needles to say that authorities concerned should continue executing sound macro-economic policy management with control of inflation as the main pillar.

In addition to that, It would be better to think about some measures to help Kip be used more widely. It is a good step forward to have established Joint Lao-Viet Bank in July 1999, opened their branch office near the border with Viet Nam and started direct exchange of currency between Kip-Dong. The Government is also planning to establish a joint venture bank with China and start direct exchange between Kip and Yuan. But Thailand, the largest trade partner for Laos, has not yet accepted Kip as a settlement currency for trade between the Lao PDR and Thailand. It would be highly desirable for people in both country if trade settlements between two countries could be done in more stable and secured way. Opening branches of banks reciprocally at the border areas will facilitate such trade settlement. To strengthen Swap arrangement between two central banks within ASEAN framework will also facilitate trade settlements and will help to support Kip value in the longer term.

Laotian authorities concerned are thinking to strengthen execution of regulations (Decree No.53) step by step. It seems that they wish to require people to price goods only in Kip by 2005 and transaction settlement between individuals to be made only in Kip by 2010, together with limiting strictly foreign currency holding of people. But regulations that will not fit for actual economic activity might ignite unrest among people again, invite instability of Kip value and expand unofficial market transactions. What they should do first is to pay full attention to stabilization of the value of the currency and not to ignite inflationary psychology again and trying to improve acceptability of Kip. It is considered that issuance of high-denominated note and/or denomination of Kip (for example, denomination of 1/100) may contribute to improving acceptability of Kip currency if the timing to do so is appropriate.

(Note) Generally speaking there are two foreign currency systems; one is the floating exchange rate system and the other is the fixed exchange rate system. If the economy is small in size and is open economy (including de fact open economy) and if it largely depends on a specific country in trade and the currency of such country is in circulation in the country, the most beneficial exchange rate system for steady expansion of trade will be the peg system (including the currency board system). If more than one currency is in circulation, adopting the currency basket system may be one realistic option.

In case of Laos, now that the foreign reserve is not enough (equivalent to only less than three months for imports), chances of market intervention for BOL are limited and it is practically difficult to operate the managed floating system. Therefore, the free floating system or the peg system with Thailand Baht which has the deepest connection in economic transactions (judging by the historical data of market rate fluctuations, it appears that Lao monetary authority adopted the Baht peg system implicitly until the Asian Crisis) or the peg system with dollar which has the largest weight in currency circulation will be another choice. The free floating system may increase fluctuation of exchange rate in case of instability and most probably push up the inflation rate of Laos because Laos depends largely on imports. If Laos adopts the peg system, it will help stabilize the value of its currency and curb the inflation rate, but it might be difficult for government people to adopt such peg system openly, because it will reduce the sovereignty of Kip and make it difficult to manage independent domestic monetary policy. Taking these factors into consideration, it may be appropriate for Laos to consider adopting the currency basket system to realize steady economic growth in the future.

7) Finance for infrastructure development and long-term credit system;

The Government and BOL are studying to separate the policy lending from commercial banks, together with establishing good governance in commercial banks management, and to facilitate finances for small-and-medium companies and for import and export businesses.

In addition to separating long-term financing functions from short-term financing functions, they need to work out a fund raising system where they can invite pension funds and funds received through postal savings into those financing functions, and to introduce fund raising methods by allowing commercial banks to undertake long-term government bonds (Please note that, in the latter case, it is strongly requested for the Government to make a clear commitment that it will not use the fund to cover the general financial deficit and will use those funds for specific businesses. This commitment is for the sake of maintaining financial disciplines and avoiding additional inflationary pressure.).

It should be noted that it is the basic condition for Lao authorities to separate financial sector from financing fiscal necessity directly, let banks operate through the market and focus more on supporting and rearing private sector.

8) Development of the capital market;

In developing capital market, introduction of a shareholding plan in major companies may help improve the environments. But more systematic approach such as allowing SOE (EDL or Entreprise des Posts Lao etc.) which show firmness in management and profitability, some local governments which have good financial balances and companies which show good performances (ex. Lao Brewery) to issue stocks or public bonds will be necessary to prepare attractive market mechanism. As a prerequisite condition for issuing stocks and/or bonds, companies should revalue their assets and have their financial statements checked by reliable auditing firms. It is desirable to get rating from international rating companies according to the international rating principles and to set as objective issuing and transaction prices of stocks/bonds as possible. Stock market will help savings mobilization of the country, push privatization of public corporations as well as strengthen own capital ratio of companies. But, in encouraging the stock market, it is highly requested for authorities concerned to make careful preparation for market schemes, primary market and secondary market, so that the creation of the market may not damage the credibility of the people toward the stock market, because it is a market with high-risk.

9) Sound settlement system;

Having a reliable settlement system is indispensable for expanding financial market transactions. With globalization of business and finance of the Lao PDR around the corner, establishment of a reliable on-line network settlement system between BOL and banks is also an urgent need to develop active inter-bank market and appropriate collateral management, including effective operations of government bonds management.

6－2 Monetary Policy Management

(1) Independency of BOL

Sharp depreciation of Kip exchange rate and high inflation rate during 1998 and 1999 were caused by financing fiscal expenditure mainly for irrigation works with direct credit from BOL, together with sharp decline of exchange rate of Baht, the outcome of monetary crisis in Asia. In 1998, BOL tried to calm down the situation through interest rate change together with the set-up of lowest deposit rate and interest rate on current account deposit (during September 1998 to July 1999), implementation of credit ceiling, sales of TB and BOL-bills. However, since direct lending to the Government continued to cover fiscal deficit, the restrictive measures produced no clear positive effects. Therefore, in 1999, BOL drastically raised interest rate on sales of BOL-bills and CD (annual rate increased from 30% to 60%), and the authorities concerned decided to stop direct borrowing from BOL. Thanks to these decisive actions, sharp brake on inflation as well as depreciation of Kip exchange rate were realized. Organizational restructuring of BOL and revision of the central bank law were also put into practice (In October 1999, Credit Department was abolished, management of monetary policy was transferred to Research Department, while daily operations were placed under Operation Department, and supervision/daily monitoring of bank activities were put under the responsibility of Supervision Department).

Monetary Policy Management of BOL after mid 1999 looks like focusing on monitoring of money supply and banks' lending attitude. Weight of prudential policy was highly evaluated because of imminent necessity to recover NPL of SCB and to restore good governance of management, so that such organizations as Deposit Protection Fund, Debt Recovery Agency and Credit Information Bureau were established one by one.

However, it is still hardly evaluated that independency of BOL in terms of the Monetary Policy Management was strengthen, because even in the revised central bank law, the article for BOL direct lending to the Government is unchanged (limit for the lending was raised from within 20% to within 25% of annual revenue of the central government for the past three years), and the right to nominate higher ranked personnel than office chiefs is still given to the Government (prime minister).

As already mentioned before, financial system seems to be subordinated to the fiscal policy in the Lao PDR. The followings are cases that should be corrected:

a) Although interest rates has been liberalized, as a matter of fact, various types of preferential lower interest rates are still imposed to commercial banks from social welfare point of view, and the interest differentials are actually born by BOL or SCB, not by subsidies from the Government.

b) As for several SOE such as Lao Aviation, the NPL might be settled through the write-off of related loans from BOL, not with fiscal expenditure from the Government.

c) For interest rate of financial assistance from abroad, although it was agreed with fixed interest rate between international institutions and the Ministry of Finance, floating interest rate was applied between BOL and SCB, which intermediate loan to SOE, thus the risk of interest rates fluctuation has been born by BOL, the issuer of currency.

d) When guidance to raise market interest rates by BOL invites the rise of interest rate of government bond issuance and therefore increase fiscal burden, there exists strong resistance against raising interest rate; this makes it difficult for BOL to change flexibly interest rate reflecting properly the market situation.

e) Now that strong domestic demands have been existing reflecting demands for infrastructure developments and house or office related investments, there is still a great concern whether strictly prioritized fiscal management could be maintained, and money supply growth could be controlled appropriately.

According to experiences in OECD countries, negative co-relationship is recognized between inflation rate and independency of central banks in terms of conduct of Monetary Policy. Miss management of monetary policy will cause huge damages to the economic activity. To conduct monetary policy efficiently, it is necessary to maintain the same policy stance for a certain period without being disturbed by political pressure from outside the bank, on condition that BOL will explain clearly and in a transparent manner the process of its policy decision-makings. Monetary policy independently managed from the Government fiscal necessity is one of the prerequisite conditions for inflation control. In this connection, inflation targeting system together with more flexible interest rate change and market operations will be one of the efficient method to realize more independent, transparent and sustainable monetary policy management in Laos.

(2) Monetary Policy Measures

(Interest Rate Manipulation)

1) As monetary policy measures are limited and the efficiency of market operations also limited, possibility for BOL to adjust demands for fund through interest rate manipulation in the market are limited as well.

There is no benchmark to be a standard for market interest rates, and the Government bond market is not well developed; Cap rate was set for interest rates for tendering/issuance of TB; there is no secondary market for government bonds issued directly to individuals and repurchase by banks is not allowed; there are only a few types of government bonds and conditions for issuance are not so attractive.

2) Interest rate change itself is not so flexible. At present, officially only two kinds of interest rates are set by BOL, overdraft (financing funds for settlement of clearing balance for commercial banks) interest rate (as of the end of 2001, annual rate 20% up to five days and 30% longer than five days, which is positioned as penalty interest) and market operation rates for BOL-bill, CD sales, etc. In the past, there was the discount window system for discounting Promissory Note (discount by official discount rate). But, the system was not operated effectively as the practice of using Promissory Notes did not came into fashion and the system was abolished in 1996. So official discount rate change has no direct influence to money market transactions. On the other hand, tendering/issuance of government bonds (TB) started from March 1994, and participants of tendering are expanded from financial institutions to the non-bank public in March 1995.

In 1999, tendering/issuance of T-Bill (January, annual rate 30%, issued for a period of six months based on discount methods) were implemented to absorb excess liquidity, and public sales of BOL-bill (April) and CD (October and December) with exceptionally high interest rate of 60% were conducted. (Their interest rates have been cut down each time when refunding afterwards, reflecting the lowering of inflation rate. The rate as of the end of 2001 is 26.4%)

SOE are also allowed to join the tendering of T-Bill. However, in fact, only banks are participating in tendering (generally, BCEL, which has the largest deposit outstanding in Laos, takes the greatest part of the tender), no corporation has been participated so far. In fact, due to 20% Cap for interest rate for tendering of T-Bill, it was not attractive investment means for corporations (Cap was abolished in 1999). In addition, for TB and others issued on public offering system, both direct acceptance and secondary purchase from the market by banks are not allowed. It is said that this is because of consideration for avoiding criticisms from the general public against banks being allowed potential monopoly of interest earnings.

BOL-bill and CD issued by BOL are sold in the market, and banks are allowed to repurchase them in the secondary market (securities transaction related law). But no secondary market transaction has been put into practice yet as market mechanism has not been satisfactory prepared.

(Note) In addition to BOL-bill, CD and TB, Savings Lottery Bond with fixed interest rate and dividend allotted by using drawing method (redeemable period: five years, nominal rate: 5%, face value: 10,000 kip. Drawings were conducted in every three months, and extra bonus equivalent to annual rate 7% in total was provided for those succeeded and divided according to the order) was issued, in April 1998, with two objectives; savings mobilization and absorption of fund surplus from the market.

3) Interest rates for deposit and loan were controlled by BOL and BOL set guideline for them until 1995. In line with the Government's price liberalization policy, BOL abolished interest rate control for loan in Kip in June 1995, and then, in principle, abolished interest rate control for deposits as well in January 1996. However, on the occasion of sharp depreciation of exchange rate of Kip, it implemented minimum interest rate control for deposit again from 1998 with the viewpoint of protecting depositors' interest.

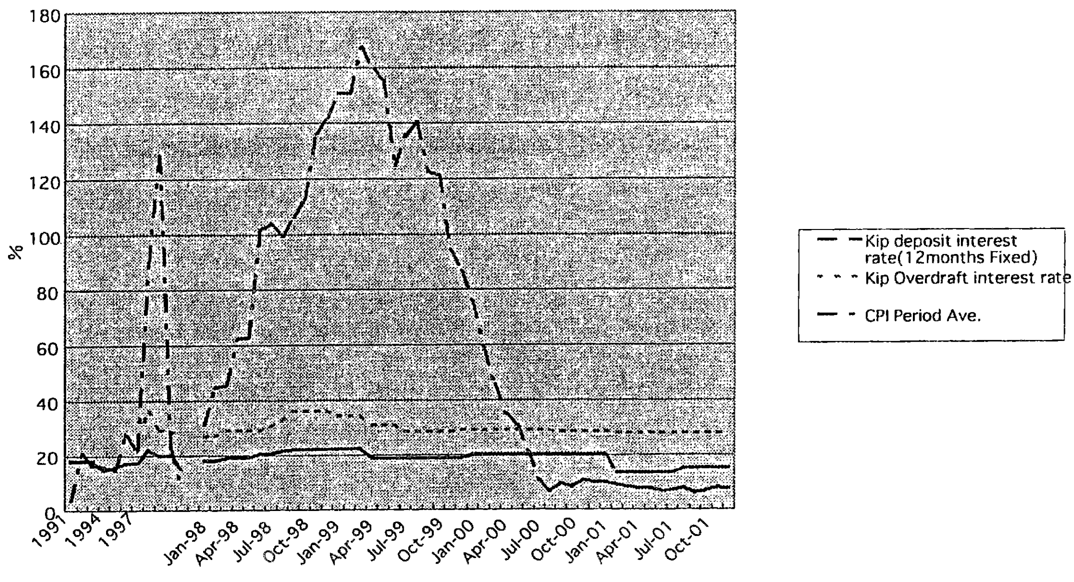
At present, interest rate for deposits of a period of a year or less is being set by each commercial bank based on their respective decision, and there is also slight difference among banks in the level of actual interest rates (note that BOL still controls interest rates for a period of more than a year). However, as a matter of fact, there are many cases in which interest rates change are applied with some indications from monetary authority.

As for interest rates for lending, they are set to lower level in accordance with the Government's priority order per industrial sector (interest rate for financing agricultural sector is being set lower than other industrial sectors and the medium-and-long term is lower than the short term).

Interest rates for deposits are determined for each period and for three kinds of currency, Kip, Baht and Dollar. Interest rate for loans are also established for each currency (same as above), period (long, medium and short-terms), industry (divided into four sectors: agriculture and forestry, industrial/handicraft manufacturing, construction/transportation, distribution/service)

4) If we look back the changes of interest rates (ex. fixed deposit of one year period in Kip), real interest rate had been in general kept positive before the Asian Currency Crisis occurred. But, from mid 1997 until mid-2000, it drastically turned to be negative as deposit interest rates were raised on a small scale, although inflation rate increased rapidly. After inflation rate calmed down later, real interest rate returned to be positive again after mid 2000. (Figure 6 — 4. Highest annual interest rate for lending was 35%; Overdraft interest rate between September and December 1998<this was 27% before the raise>.) After 1998, additional interest rate to Current Account (from September 1998 to July 1999), interest rate adjustment for Savings Account and Fixed Deposit (after lowering overall interest rates around mid 1999, interest rates only for deposit in Kip were raised on a small scale again), and long-term Fixed Deposit with two years term and daily saving (in July 2000) were introduced.

If we look at the level of interest rate currency by currency, a margin of approximately 0.2 to 0.3% added on interest rates of SIBOR to deposit interest rate in dollar. However, deposit interest rate in Baht is generally lower than that in dollar due to operational restrictions already mentioned (at this moment, deposit interest rate differences between currencies look like generally equivalent to those of past exchange rate fluctuation rates during the corresponding period). In the past, it is noted that there were some speculative investments aiming to obtain profit from foreign exchange fluc-



(Note) source: data from BOL

Figure 6 — 4 Interest rate and Inflation rate

tuation, by raising funds in Baht in Thailand or Laos, converting into dollar through Kip, and changing into Baht again in Thailand (under some circumstances, conversion of dollar into baht also happened). In order to prevent such speculative funding, flexible interest rate changes reflecting real interest rate should be required.

(Reserve Requirement System, Liquidity Ratio Control, and others)

1) Operation of reserve requirement system is also rigid. Reserve requirement ratio is fixed mainly from the viewpoint of maintaining soundness of banks; banks should reserve as deposit at BOL at all times through the following month; the calculated amount based on the balance of deposits as of the end of the month before (0.5% interest rate is added to the amount of reserve deposit). The Bank reviewed the reserve requirement ratio last autumn and now, the ratio for deposit in Kip less than 15 month is 8% and 12% for deposit in Baht and dollar less than 15 month (that is, cost of receiving foreign currency deposit is, generally speaking, higher than that of Kip deposit, if foreign exchange rate fluctuation taken into consideration). Changes in reserve requirement ratio should have a large impact on lending activities of banks, because it will influence directly to banks credit creation function, but such effects seems to be considerably reduced in the present situation where loan/deposit ratio is as low as 50-60%.

2) Other than reserve requirement ratio, a variety of regulations are imposed upon banks from prudential policy point of view, such as liquidity ratio, cash in hand ratio, lending/funding ratio, loan/deposit ratio, loan to a major customer ratio, deposit abroad ratio and return on asset ratio (the reserve deposit balance is included in calculation of several regulations such as liquidity ratio, etc.).

   Regulations other than reserve requirement ratio are as follows:

   - Liquidity ratio: 10 % of capital(20-25% before 1999)
   - Cash in hand ratio: 4-8% of the balance of deposits
   - Loan/deposit ratio: loan should be 60-80% of deposits amount
   - Lending/funding ratio: the amount of lending and investment on securities should be less than 30% of that of funding
   - Loan to a major customer ratio: the balance of loan to one major company should be less than 10% (25% according to fund scale of a bank) of own capital
   - Deposit abroad ratio: balance of Nostro account should be less than 20% of total as-

sets

・ROA ratio: higher than 3% of total assets

・ Capital adequacy ratio: higher than 8% of total assets

・ NPL ratio: less than 5% of total loan amount

3) Moreover, in order to ensure smooth daily settlement of clearing balance, banks are requested to have "Clearing Deposit" separately from reserve deposit at BOL. If any deficiency occurs, BOL, in principle, mediates banks to let them procure necessary fund from inter-bank market (BOL charges 0.2% for mediation commission). However, in case that banks fail to fulfill clearing balance shortage by the designated settlement time (15:00), BOL supplies bridge loan as Overdraft (maximum term: two weeks, interest rate: 20% up to five days and 30% longer than five days).

In addition to deposits mentioned above, compulsory deposit to retain constantly a certain percentage of capital is required by BOL (withdrawal of this deposit is possible only for the approved use such as funding for the Government or government-related usages such as loan to SOE).

However, in the present situation where collateral and guarantee systems are not satisfactory developed and accounting information of each company is not being fully disclosed, if banks are strictly required to satisfy regulation on loan/deposit ratio of 60-80%, prudential requirement for banks may come into question, because it would be difficult to find sound borrowers. If banks dared to extend loan up to that ratio, loan evaluation criteria should be eased and new NPL problem would be occurred, or, they might exceed the loan to a major customer ratio. Such is the current situation, not a few banks are requesting modification of the regulations, pointing out that all of the above regulations may not be realized at the same time.

(Credit Control)

1) Main measures to control credit is monitoring of credit increase by BOL; the credit ceiling system (bank by bank) was applied for long (the system was abolished at once in 1996, but then reapplied in 1998 to deal with contagion effects of currency crisis in Asia-but instead of "bank by bank" type, targeted increase ratio was introduced for the total amount of loan balance of banks). BOL is monitoring development of loan balance of banks (targeted increase ratio is annual rate of 18% or less) aiming at annual increase rate of +7% for Base Money and +20% or less for money supply (M2). However,

as a matter of fact, recent growth rate of bank loans seems to be higher than the target rate and, since there seems to be no strong penalty even if banks do not respect the target rate, it seems that the target of credit and money supply increase is a mere moral suasion.

2) Loans to SOE from BOL are stopped since 1999. Existing loans are only for five companies; airplane purchasing for Lao Aviation, supporting funds for Cement Factory (funding resource is loan from China), EDL (loan from foreign countries), etc. Now SCB are providing new loans on a commercial basis in place of BOL (in fact, Banque pour le Commerce Exterieuer <BCEL> was handed over majority of loans from BOL as this institution has the largest availability of funds.)

BOL loans include finances to APB based on aids from international organizations accepted as funds for agricultural development, and those provided to BCEL from BOL in the form of deposit in foreign currency when the former was to open a correspondent account in abroad.

3) According to the budget, Advance loan of BOL to government is limited up to 25% of average annual government revenue for the past three years; generally, up to 1/12 of the applicable amount is automatically financed every month. In case of emergency, it is possible to add extra loan with a "special letter" from the Minister of Finance. Upon the suspension of advance loan of BOL in mid 1999, the Government strengthened its effort to increase tax collection, and reviewed priority levels of government projects while postponing or stopping execution of projects whose priorities are relatively low. At present, the main ways for the Government to get short-term funds are issuances of TB, and borrowing from foreign exchange fund, which is positioned as an emergency case (although direct borrowing from BOL is still possible from the legal point of view, as already mentioned).

However, currently demands for bank lending show an increasing trend led by increase of construction related projects. Suppose that such demands are financed by loans from banks using deposits in foreign currency as funding resources, exchange rate risk would be implicitly included due to miss match of periods between loans and deposits in foreign currency, and even if repayment of borrowed money is scheduled (according to the definition, new loans having government guarantee for payment are not considered as risk assets), payment could potentially be deferred if government's tax revenue deficiency continues. This might cause payment arrear and become possible NPL in the future. So, it is necessary to pay full attention to the Government fiscal position in the coming future.

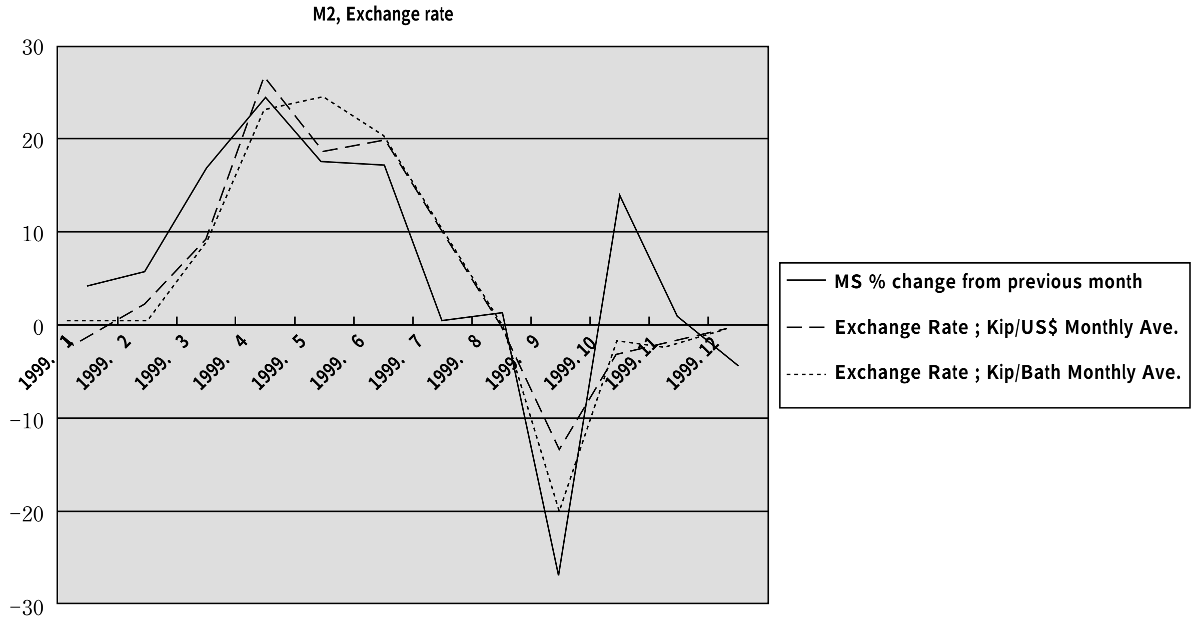
(Measures for Liquidity Absorption from the Market-Operation)

1) As already mentioned before, BOL attempted to absorb excess liquidity from the market through tendering/issuance of T-Bill from March 1994, issuance of BOL-bill from 1995, issuance of TB using public offering method in 1996 and public sales of CD from 1999.

Although interest rates of BOL-bills and CD issued in 1999 were highly negative compared with inflation rate at that time (annual inflation rate reached nearly 160% in first half of 1999), there were strong criticisms even within the Government, pointing out that payment for interests would generate new issuance of money and accelerate inflation, due to high level of nominal interest rate (annual rate 60%; until then, the maximum interest rate for the operation was 30%), although the interest rate was highly negative in real term. Thus, as the inflation rate declined, interest rates were lowered along with each roll over, and the present interest level is down to 36%. On the contrary, although current real interest rate is extremely high (annual inflation rate is as low as around 7%), there is no outstanding criticism about the interest rate level. Considering such arguments, recognition of difference between nominal and real interest rate has not yet sufficiently understood even within the Government. It is necessary to facilitate general understanding on the role of interest rate to have understanding for flexible interest rate management in financial market.

2) It is very interesting that the issuance of high interest bonds was effective to absorb excess liquidity from the market, although the real interest was negative (a fall of Kip exchange rate bottomed up in the autumn of 1999; Figure 6 — 5).

If we look back the process of market liquidity absorption since November 1998, approximately 4% of money supply was absorbed through issuing TB, BOL-bill and CD by April 1999, but there was no outstanding change of quotation in foreign exchange market. Authority continued to absorb, up to October 1999, 9.5% of money supply, equivalent to about 1.5% of nominal GDP. Due to this, Kip exchange rate appreciated in September 1999. Operation for liquidity absorption through issuance of BOL-bill were continued further and eventually absorbed approximately 10% of money supply and about 1.7% of nominal GDP from the market by March 2000.



(Note) the same as Figure 2

Figure 6 — 5 Change of M2 and Exchange rates

When Kip exchange rate was weakened again in the middle 2001, mainly because of government's tax collection deficiency (increase of fiscal deficit) and short-covering of foreign currency for financing buy back operation of stocks of Lao Brewery, BOL again attempted to absorb funds through BOL-bill sales. From June 2001 to the end of the same year, BOL absorbed funds from the market equivalent to 2.5% of money supply and about 0.5% of nominal GDP (based on the prompt estimation). Kip exchange rate has been stabilizing at the level of around 9,500 kip/US$ since last November.

According to the process described so far, the operation of liquidity absorption in Kip in financial market, although whose market scale is small and limited, changed the balance between foreign currency and Kip and gave clear influences to the price formulation in the foreign currency market.

During this period, the balance of corresponding accounts of banks (especially Nostro a/c) also showed sharp fluctuations (seasonal fluctuations such as tax collected on a large scale from July to the end of September included). And, calculating through a whole year from March 1999 to next March, funds movements of Nostro account exceeded the total amount of BOL operation. Also between June and November 2001, a fund about twice as much as BOL operation was shifted back from abroad. Looking at such kind of flow of funds, it may be possible to reason as follows: BOL operation influenced currency selection by people, changed the demand/supply balance between Kip and foreign currencies in the market and generated Kip shortage in the domestic market; small market size helped very much for the change. Looking at the change, banks called back funds of Nostro account from abroad, which pushed turn over of exchange rate. One condition should be noted for such mechanism to be workable; the turn over of foreign exchange rate in favor of Kip could be realized under the conditions that domestic companies, at least some big companies, who have demands for foreign currency or capacity to raise foreign currency lending from abroad would cooperate with the BOL/government to maintain Kip value, or would at lease not take speculative opposite actions.

3) As for measures to prevent Kip exchange rate fluctuation, foreign currency market intervention and such drastic measures as suspension of the license for exchange dealers have been taken before. Changes of reserve requirement ratio were also effective. However, such direct measures should be applied very restrictively because, if not, market mechanism itself will be distorted and make people lose confidence to authorities. Effect of changes of reserve requirement ratio is also limited now that banks have much reserve surplus.

4) BOL operations to absorb liquidity from the market is a sell-out operation, and it is not necessarily a flexible measure for adjustment of daily fluctuation of demand and supply for funds. In order to expand the efficiency of market operations, it is necessary to have variety of operations through promoting the bill market and TB market, especially encouraging TB market.

(3) Recommendations to Strengthen Effectiveness of BOL's Monetary Adjustment — To activate Inter-bank Market transactions and develop TB Market —

If the financial system and financial market are developed, distribution of funds necessary for economic activities would be facilitated further and fund management of the Government as well as corporations would become smoother with lower costs. People could have more attractive financial products and more opportunities to raise financial income, which would increase chances for savings mobilization. In other words, to activate and expand financial transactions in the market, it is essential to produce variety of financial goods that can attract funds from people, and to provide a good market framework for raising funds and investing them with smaller risk.

As resources, budget as well as human, to be applied to the financial market reform are limited, policy priority is now given to solving NPL problems with assistance from ADB. However, the reform of financial market is important and efforts to develop effective inter-bank market and TB market should be started immediately, because it will help banks develop sound banking business. Measures to mobilize domestic savings and establish an efficient fund allocation scheme (study of new lending scheme and capital market) should be dealt with as a longer-term project.

(Note) Characteristics of current inter-bank market situation

a) Tools as well as collateral system for financial transactions are not yet developed (settlements using bills, certificates, etc. are not so prevailing and TB market undeveloped).

b) Short-term financial investments scheme such as overnight call and day-to-day accommodations are not put into practice, and very limited chances for financial transactions because of high-risks.

c) There is no stable fund supplier due to insufficient savings mobilization and restrictions on banking activities.

d) Market rules for financial transactions (such as Security Codes) are not yet widely settled (especially, reliable collateral and guarantee system has not been established), and enforcement of laws to deal with disputes is not complete.

Followings are recommendations to increase efficiency of Monetary Policy by BOL and to develop financial market.

1) Conduct of Monetary Policy;

As for conduct of market operation, more flexible interest rate change reflecting real and effective interest rate should be employed together with reviewing and revising existing regulations of ratios imposed upon banks taking current funding/lending(investment) situation of banks into consideration. To have variety of tools of market operation by preparing variety of TB will also increase efficiency and flexibility of market operations. In these connections, further strengthening of BOL autonomy for conducting Monetary Policy will be highly desirable; introduction of such system as inflation targeting should be studied to satisfy higher accountability of BOL.

In addition to the strengthening of BOL functions, revision of staff employment system and their training will be also important; regular and open employment system to hire personnel should be proposed. It is also desirable that personnel employment through indiscriminately selection would be essential not only for BOL but also for the overall employment of any types of public servants. If such system will be introduced, it will ensure regular recruitment of competent and efficient staff members and enhance the quality of public administration services.

2) Actions to Activate Inter-bank Market Transactions;

In regard to development of inter-bank market, report prepared by the consultant of ADB has been submitted (published in 1998: ADB TA 2643-LAO), and a part of recommendations is already coped with. But, full-scale actions have not yet been taken. It is recommended to establish a special task force (together with the participation of banking association) to prepare Action Programs for establishing transaction rules in the market, collateral and guarantee scheme, code of conduct etc., and implement it (BOL and the ministries concerned should give highest priority for this issue). Transaction rules in foreign exchange market whose framework has already been established would be a good starting point for the discussions.

As for foreign exchange market transactions, since direct exchange of foreign currencies has not been approved (exchange is done through Kip), foreign banks, as a matter of fact, do not participate in market transactions with Lao banks to avoid high costs of exchange. Therefore, it will be necessary to review further the market framework, especially taxation, commissions, collateral and guarantee scheme.

Increasing the credit worthiness of Lao banks is another essential conditions for inviting foreign banks to join more actively in inter-bank transactions. Along with execution of disclosure, each bank should aim to obtain appropriate international rating in the future, through settlement of NPL problems and establishment of good governance

2) Development of TB Market;

In Laos, pension fund for civil servants and corporate employees, postal savings, and micro finance activities have been made up, but opportunities for investment are very limited. If such funds could be accumulated and reinvested in financial goods that will ensure fixed interest earnings, such funding activities will be encouraged. TB market could be one of such opportunities.

Issuance of T-Bill started from March 1994 in Laos (twice / month; in principle, issued regularly on every other Thursday), and the registration system of ownership already exists (controlled by the Ministry of Finance). Therefore, to build up a system for prompt and reliable registration handling, to apply preferable taxation and/or tax exemption, and to clearly differentiate the characteristics between shot-term T-bill issued for government's short-term fund management and mid/ long-term government bonds (T-bond) issued for raising development project's funds.

In addition, following measures will be necessary: issue TB regularly to secure necessary market size; aim at forming yield curve by diversifying brands and terms of issuance; allowing banks to acquire TB issued through public offering to encourage the development of secondary market; review the registration system in order to apply it for BOL's operation and collateral for inter-banks transactions; expand the market transactions by allowing acquisition by foreigners and foreign banks (the task force mentioned above will be used for this issue, too). The ADB report already discussed this issue, so reviewing propositions stated in the report would be the realistic starting point.

(3) Construction of Sound and Robust Financial System; Dealing with NPL Problems

1) Although NPL ratio of SCB is getting improved, the level of ratio is still high. A half of NPL is caused from loans to SOE the share of which is about a quarter of the total outstanding of loans. The key to solve NPL problems is to establish good governance of SOE (World Bank and IMF are recommending SOE reform, too). Most of loans to SOE were generated, at first, from direct lending of BOL, then, since 1999, SCB took responsibility for new loans, except for some cases of foreign loans to SOE which BOL continuously manages.

2) In regard to SOE management, there are cases in which necessary depreciation is not reserved, and although overdue credits they have, they do not have enough autonomy for setting prices for their products to cover their production cost. If accounting of SOE were not conducted properly according to the clear and rational accounting principles, it would be difficult to solve NPL problems. For SOE that is requested to maintain lower prices from social point of view, necessary funds to cover its costs must be subsidized by government fiscal expenditure not by BOL loan and/or bank credit, because credit from banks may cause increase of money supply (inflation) and another NPL. In particular, damaging the balance sheet of BOL would harm Kip currency value and create a new inflationary pressure to the economy.

3) Since 1998, BOL and the Minister of Finance have been dealing with NPL problem with assistance of ADB. Six SCB merged into two banks in 1999 to strengthen their management. At present, there are four SCB, including APB, the special bank for agriculture sector. It is said that through the merger, collection of NPL has been reinforced (Internal NPL Recovering Unit was set up in each SCB to promote collection of NPL, and after merger, negotiation power of banks to collect NPL has been reinforced and local authorities have become more supportive for debt collection); loan conditions have been reviewed and determined appropriately (up to that time, there were many cases in which short-term loans were extended without matching terms of loans with that of the project); NPL ratio has been improved down to 40% or less (approximately 60% before the merger of national banks) at present, thanks to the collection of loans and increase of loan outstanding reflecting recovery of business since last year (according to an international organization, NPL ratio at the end of 1999 was about 70%).

However, outcome of merger vary from bank to bank. Some banks show decrease of profit after merger as administration fee increased. Low capital adequacy ratio and profitability are still conspicuous. Under such circumstances, the authority is planning to merger two SCB into one in the near future.

Capital injection by the Government was expected in line with the merger of 1999, but it has not been implemented yet. It is reasonable to consider that without establishment of good governance, injected money as new capital might be wasted again. It is now agreed that capital injection should be realized in accordance with the establishment of good governance within the targeted banks. Banks are focusing on increasing transparency of the management through setting strict evaluation standards and clear accounting rules based on global standards and increasing efficiency of daily operations. Application of outside auditing companies and promotion of disclosure are also under consideration. As establishment of good governance is the key for sound management, on going bank reform processes should be completed as early as possible .

4) As for method for injecting capital, there are already many examples of capital injection using government bonds in neighboring Asian countries. In Laos, most feasible way of injecting capital may be exchange of government bonds with stocks. In this case, zero coupon government bonds (no interest rate) would not be so much recommendable because they do not provide interest income to the beneficiary banks, and effects of capital injection will be limited; acquisition of funding resource for repayment

of NPL, and temporary improvement of capital adequacy ratio (of course, if government bonds were supplied with discount value, as profits on redemption would be expected, it would be possible to distribute these profits for each fiscal year as interest earning). Moreover, in the present situation where it is difficult to monetize injected government bonds as there is no secondary market, it is highly possible that BOL will be requested to monetize them by undertaking them. In this case, if the Government failed to redeem government bonds held by BOL within a certain period, and to collect additionally supplied money from the market, inflation would accelerate in the face of significant pressure of excess liquidity in the market and possible financial disintermediation. In this connection, good governance of government (clear government bond management policy and strict management of fiscal deficit), along with that of financial institutions, would become the decisive factor for the success of capital injection.

5) International institutions such as ADB, World Bank and IMF are currently providing supports to establish sound financial system in Laos (accounting standards are also being arranged with the help of ADB and World Bank). The NPL Steering Committee, The NPL External Collection Committee was created to solve NPL problems. The internal NPL Recovering Unit was also established in each SCB and it is now reviewing strictly NPL with clear evaluation standards. However, it seems that collection through drastic settlement such as liquidation has not yet been put into practice for loans to corporations, partly with consideration for maintaining employment.

In regard to accounting standards of corporations, National Audit Authority was established in 2000. The Authority is now auditing government organizations, SOE and big private companies in cooperation with foreign audit companies. To support government efforts, the World Bank and ADB started a new assistance program from the latter half of 2001 in financial sector. It is quite fruitful to keep close contact and cooperation between JICA and the World Bank/ADB project for the success of financial sector reform in the Lao PDR.

Table 6－8　Some Management Indexes of SCB (%)

[commercial banks total]	End of 1995	End of 1997	End of 1999	End of 2000	End of 2001
Own Capital ratio (against total assets)*	12.2	13.6	13.6	12.2	12.4
loan/deposit ratio	86.3	80.8	51.6	55.5	61.4
share of loan to SOE within loans	13.1	17.4	23.1	18.9	27.4
NPL ratio		60-70		40	

(Note) *Own Capital ratio is before adjusting NPL.

	BCEL	Lane Xang Bank	Laomay Bank	APB
Capital adequacy ratio (against total assets)*	2.4(3.3)	2.61(3.3)	1.86(3.13)	4.21
Loan/deposit ratio	41.4(46.9)	33.6(42.1)	37.6(49.7)	134.6(197.2)
Return on assets	1.2(2.9)	0.45(1.57)	1.51(1.27)	6.26(4.58)
Deposit interest ratio	0.035 (0.0304)	0.084 (0.0937)	0.0471 (0.0429)	0.0026 (0.0965)
Loan interest	0.0328 (0.0382)	0.0461 (0.0686)	0.063 (0.0496)	0.0113 (0.1)
Difference between interests of deposit & loan (above)	－0.022 (0.0078)	－0.0388 (－0.0251)	0.0159 (0.0067)	0.087 (0.0035)
Administration cost ratio (against total assets)	0.0158 (0.0354)	0.0796 (0.0537)	0.0385 (0.0345)	n.a.

(Note) * Capital adequacy ratio is before adjusting NPL. Figures of BCEL, as of 1998 (between parenthesis; 1997), Lane Xang and Lao May, 1999 (do;1998) and APB, 1999 (do;1997). Loan/deposit ratio does not include inter-bank deposit.

Policy recommendations :

1) To establish efficient and credible financial system in the Lao PDR

① (IM-ST) To develop supportive financial system such as refinance system and credit guarantee system for SME and export related companies

② (IM-ST) To review branch policy by allowing foreign banks open sub-branches outside Vientiane municipality (cf. ⑦ below) and to improve banking services, together with expanding support for postal savings, micro-finances, and cooperative type financial institutions

③ (IM-SMT) To prepare necessary laws and regulations, especially on accounting and security transactions, and to establish more efficient judicial procedure

④ (IM-SMT) To realize reliable accounting system by revaluing assets and liability of companies including proper execution of depreciation and application of clear-cut measures like liquidation of failed companies should be urgent necessity to realize due diligence

⑤ (IM-SMT) To establish sound and reliable settlement system (cf. 2) ② , ③ below)

⑥ (IM-MLT) To separate policy lending from commercial banking and to prepare financial scheme for infrastructure development and long-term credit

⑦ (SMT) To improve management know-how of banks, introduction of regular and open staff employment system through indiscriminately selection, systematic staff training, as well as closer cooperation with foreign banks through tie-up should be considered

⑧ (SMT) To stabilize Kip value by facilitating conversion between Kip and other currencies with allowing reciprocally to open branches in border areas and establishing SWAP agreement with neighboring countries, especially Thailand

(MLT) To prepare infrastructure for future capital market by establishing sound reliable accounting system, promoting external auditing and disclosure

2) To increase efficiency of monetary policy

① (IM) To change interest rate more flexibly reflecting real and effective interest rate and to review existing regulations of ratios toward commercial banks

② (IM-ST) To establish reliable collateral and guarantee system, code of conduct for market participants and transparent market transaction rules to develop inter-bank and TB market

③ (IM-MT)To develop active TB market for smoothing Government funding operation and budget management, to enlarge people's financial investment possibilities, to give variety of market operation tools to BOL and to increase efficiency of monetary policy adjustment by BOL, and to monetize injected bond to SCB, if capital injection using government bonds would be realized in the coming future

(Note) IM; to start immediately, ST, MT, LT indicates Short-term, Middle-term and Long-term time span will be needed for execution.

Table 6 — 9　Development of Monetary Policy Measures and Prudential Policy of BOL

－1991
- Regulations on advance loan to the Government (ceiling is set to the Government budget)
- Credit ceiling system (a ceiling set on loan from SCB to SOE)
- Introduction of Credit Deposit Ratio (it is mandatory to deposit 10% of the total loans at BOL)

－1995
- Manipulation of deposit and lending interest rates (BOL-set guidelines, liberalization of interest rates for deposit in Kip in '95/6)
- Introduction of discount window system ('94)
- Application of credit ceiling (bank by bank)
- Introduction of Reserve Requirement Ratio
- Introduction of TB auction ('94/3)
- Sale of BOL-bills by public offering

－1997
- Liberalization of interest rates regime ('96/1)
- Credit ceiling (abolished in '97) and moral suasion

－1998
- Reintroduction of regulation on minimum deposit interest rates
- Reintroduction of the credit ceiling system
- Transfer to SCB of BOL lending to SOE and agriculture-related loans

－1999
- Sale of high-interest-rate TB, BOL-bills and CD by public offering
- Issuance of Saving Lottery Bond
- Suspension of direct lending to the Government (advance Loan)
- Bank restructuring (6 banks merged into 2)
- Establishment of the Depositor Protection Fund
- Establishment of the Credit Information Bureau

－2000 and after
- Monitoring of increase of lending of banks
- Strengthening of bank supervision function of BOL to give guidance on sound banking (establishment of the Asset Collection Committee)
- Advanced redemption of high-interest-rate TB and BOL-bills, downward revision of interest rates at each rollover, and repeated operation to absorb money from market
- Hike of Reserve Requirement Ratio (12%)
- Liquidity ratio lowered
- Interest rate for market operation lowered successively

(Notes)　This table was created based on papers prepared by BOL.

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(Attachment1) Development of Monetary Policy Measures in the Lao PDR

	By 1991	By 1995	By 1997	1998	1999	2000 and after
Interest Rate Policy		Liberalization of interest rate for lending in Kip (95/6)	Liberalization of interest rate for deposit (96/1, except for deposits of more than one year)	Minimum deposit interest rate BOL is still setting guideline for deposits of more than one year		Pre-maturity redemption and reduction of interest rates of high interest bills
Reserve System		Reserve Requirement Ratio (12% from 95/6; except for foreign currency deposit of more than one year)		Reserve Required currency by currency (Kip, baht and $) (98/6)		Reserve Requirement Ratio exempted for foreign currency deposits of one year and longer
Direct Control of Bank Credit	Discount Window system (94) Credit Ceiling to SOE from SOCB	Credit Ceiling (bank by bank)	Abolish the Discount Window (96) Abolish the Credit Ceiling Monitoring and moral suasion	Re-implementation of Credit Ceiling (not by bank but on an all-bank aggregated base)	Setting target growth rate for base Money and Money Supply and monitoring	Monitoring of money supply

Market Operation		T-bill auction (94/3) BOL-bill auction (95) Participants for TB auction enlarged to non-bank (95/3)	Selling BOL-bill to the public (96/9) Selling TB to the public (96/10)	Selling BOL-bill to the public (98/1)	Abolish the Cap of interest rate for auction Selling High Interest rate TB and BOL bills to the public (99/1,4) Selling BOL-CD to the public (99/10,12)	Selling TB, BOL bills and CD to the public (01/6-)
Supplemental Measures	Credit Deposit Ratio (10%)			No more new BOL loan to SOEs Savings Lottery Bond (98/4)	Stop Advance to the Government (99/9) Bank Liquidity Ratio lowered to 10% Deposit Protection Fund Credit Information Bureau	Enforcement of Bank supervision

7. Lessons from the Asian Financial Crisis
– A Case of Indonesia –

Masaaki Komatsu

7 — 1 Introduction

This paper attempts to draw lessons from the recent Asian financial crisis started in the summer of 1997. After the financial deregulation policies introduced by the South East Asian countries in mid 1980s, along with integration of these countries into the international financial markets, massive foreign inflows persisted. Then the sudden turn around of capital flows triggered by Thai Baht crisis led the South East Asian countries into the financial crisis.

Since there are some differences in background and occurrence of the crisis among those countries, there are more similarities in causes and consequences. The most important similarities highlighted elsewhere are massive capital inflows and outflows and weak banking system. These two features are also common to today's Lao economy. The lessons drawn from the Asian countries facing crisis would, therefore, contain important and valuable implications to the Lao's economic management. The country chosen as a case study is Indonesia, which was hit most seriously by the crisis and may have common economic features with Laos, including a large government owned banking sector.

The first two sections following the introduction discuss causes of the financial crisis. The current financial crisis in Indonesia originated mainly from its heavy reliance on foreign capital and the weak banking system. Then the following questions arise. (a) Why massive capital inflows continued over the last 10 years? (b) Why was Indonesian banking sector weakened? What was the problem with the banking sector? Section 2 and 3 try to answer these questions. Section 4 discusses consequences of the crisis. What happened to the Indonesian banking sector by the crisis? How the currency runs related to collapsed banking sector? Section 5 discusses major lessons to the Lao’s economic management drawn from the Indonesian financial crisis. The last section is a conclusion.

7 — 2 Causes of the Crisis-International Capital Inflows

(1) International Capital Inflows

Over the last ten years, international capital inflows to Southeast Asian countries have been spurred. In particular, private capital flows have surged rapidly [(1)]. In sharp contrast, net official flows declined as a source of external finance during this period. Private capital flows have far exceeded official flows in the 1990s. The countries in this region have entered a new age of globalized and integrated international capital flows. This is an evident from changes in the financing structure of the Indonesian balance of payments (Table 7 — 1). The Government's role in financing Indonesia's balance of payments became negligibly small (in net basis) during the 1990s, while the private sector's role increased substantially from almost nil in 1989 to over US$ 13 billion in 1996. The shift of capital flows from official to private sources matched the shift from the Government taking the leading role in economic development to the private sectors taking the lead during the last ten years.

The changing composition of capital flows has weakened the ability of Indonesia's external debt management system and role of international aid consortia (Consultative Group for Indonesia: CGI) in supervising its external debt. The Indonesian Government and international consortia have not developed a system to manage external debt under the new age of globalized and integrated international capital flows.

A continuation and concentration of capital inflows have been closely linked to the macro economic performance of the recipient countries and the economic boom in the Southeast Asian region. In theory, the potential benefits of international capital inflows are clear. The capital flows are directed toward the world's most productive investment opportunities, thus increasing economic growth. On the other hand, there is an increasing vulnerability in the less developed countries' (LDCs) economies because of heavy dependence on foreign capital and exposure to excessive external debt as a consequence of the integration into international financial markets.

Despite government policies to curve capital inflows and to slow down overheating economies, private capital flows remained surprisingly robust and continuous until the summer of 1997 when the financial crisis hit Southeast Asian countries. The following section discusses causes and mechanisms of such capital inflows into the Indonesian economy.

Table 7 — 1 Balance of payments and its Finance

unit:million US dollar

	current account	capital account		
		government	private	change in reserve
83/84	-4,151	4,783	1,191	2,070
84/85	-1,968	2,227	499	667
85/86	-1,832	1,788	572	30
86/87	-4,051	3,343	1,232	-738
87/88	-1,706	1,526	1,709	1,586
88/89	-1,859	2,825	-211	-677
89/90	-1,599	1,830	575	248
90/91	-3,741	924	5,856	3,302
91/92	-4,352	1,418	4,133	981
92/93	-2,561	915	4,284	1,439
93/94	-2,940	1,063	4,648	727
94/95	-3,488	105	4,645	616
95/96	-6,987	-209	11,672	2,651
96/97	-8,069	-820	13,488	3,898
97/98	-1,699	4,199	-11,828	-10,103
98/99	4,609	12,562	-9,645	9,233
99/00	6,167	3,178	-9,001	4,120

source: Bank Indonesia, "Indonesian Financial Statistics," Sept. 1997

(2) Interest Arbitration

Economists assume the basic principle of the "law of one price". It means that under free capital mobility an asset's price must be equal wherever the markets are. In this context, a domestic interest rate must equal to an interest rate in international markets plus forward cover. This relationship can be expressed in the following equation:

$$i = i^* + fp \qquad (1)$$

(i : domestic interest rate; i* : interest rate in international markets represented by the US dollar at the Singapore Inter-bank Offering Rate, SIBOR; fp : a forward exchange rate premium)

Forward foreign exchange was traded only on a bilateral basis in Indonesia and there was no official statistics for forward premium available. Through various discussions with Indonesian banks and institutions, it can be concluded that the level of domestic interest rates (i) has remained far higher than the sum of the international interest rate and the bilateral forward exchange rate premium (i* + fp) for most of the time until the summer of 1997. In theory, the forward premium can be divided into two factors; expected exchange rate and risk premium. Since there was no indicator for the expected exchange rate, an actual rate of rupiah depreciation was used as a substitute for the expected exchange rate changes. Then the above equation can be written as follows:

$$i = i^* + e + rp \qquad (2)$$

(e : actual change in foreign exchange rate as a substitute for the expected depreciation rate; rp : risk premium)

This is a typical equation explaining interest rate arbitration that appears in economic textbooks. The last item of the equation (2), (rp) is equal to (i-i*-e) which represents an implicit risk premium. It is evident that the risk of holding Indonesian rupiah, i.e. the risk premium, has declined from 1980s to 1990s as the Indonesian economy continued to develop and its economic management remained in line with those of the World Bank and IMF. It is also evident from observing the behavior of domestic and foreign investors that their perceived risk premium has declined substantially to a negligible level towards the mid 1990s. However, the calculated implicit risk premium has reached around 12% between 1990 to 1993 and remained at around 6% between 1993 to 1996 (Table 7 — 2). These calculated risk premiums were much higher than the risk investors perceived. In other words, the left hand side (domestic interest rate) of the equation (2) has been continuously higher than the right hand side (covered international interest rate)(2). This

Table 7 — 2　Interest Rate Differencials

end of period
unit: billions of rupiah, %

	rp/US$	change in rupiah rate(e)	change in CPI(pc)	change in CPI in US(pc*)	SIBOR (i*) 3months	rp deposit rate(i) 3months	i-i*	i-(i*+e)	i-(i*+pc-pc*)
85/86	1,133	2.60	5.70	3.80	8.00	14.70	6.70	4.10	4.80
86/87	1,652	31.40	8.80	1.90	6.40	15.20	8.80	-22.60	1.90
87/88	1,663	0.70	8.30	3.73	7.40	17.40	10.00	9.30	5.43
88/89	1,753	5.20	6.60	3.97	10.20	18.00	7.80	2.60	5.17
89/90	1,823	3.80	5.50	4.82	8.50	16.20	7.70	3.90	7.02
90/91	1,932	5.60	9.10	5.38	6.40	24.20	17.80	12.20	14.08
91/92	2,017	4.20	9.80	4.28	4.40	21.30	16.90	12.70	11.38
92/93	2,071	2.60	10.00	3.00	3.82	18.21	14.39	11.79	7.39
93/94	2,144	3.52	7.04	2.98	3.38	13.42	10.04	6.52	5.98
94/95	2,219	3.50	8.57	2.53	4.91	13.63	8.72	5.22	2.68
95/96	2,338	5.36	8.86	2.82	6.00	17.22	11.22	5.86	5.18
96/97	2,419	3.46	5.17	2.92	5.52	17.09	11.57	8.11	9.32
97/98	8,325	244.15	34.22	2.30	5.75	22.15	16.40	-227.75	-15.52

implies that the interest arbitration did not take place throughout this period. This is why massive capital inflows continued and the external indebtedness increased without limit. The above imperfection in the interest arbitrage may have resulted from imperfect adjustments in underdeveloped domestic financial and foreign exchange markets, including the forward markets.

Perfect arbitration in interest rates under the free capital mobility, in other words the "law of one price", assumed by typical economic textbooks did not hold in Indonesia over the last ten years. This fact was also observed in many other countries, particularly in developing countries where domestic financial markets and foreign exchange markets are still in the early stage of development. As a result, one-sided capital inflows continued for a long period until the crisis burst.

Now we turn to the interest rate arbitration equation from the borrowers' point of view. The relationship can be expressed by adding domestic banks' margin (m) over the deposit rates and margin in the international financial markets (m*) over the SIBOR respectively to the both sides of the equation (1).

$$i + m > i^* + fp + m^* \qquad (3)$$

Indonesian firms, which have access to the international financial markets, faced the equation (3). Domestic banks margin over the deposit rates remained between 4 to 5 % while the margin over LIBOR offered in the international financial markets were much less, at most 2 %(3). This encouraged major Indonesian firms to rely more on the external financings. As a result of the shift of major Indonesian firms to the international financial markets, the domestic banks were left to deal with lesser quality of borrowers. This maintained domestic banks margin higher, which again encouraged major Indonesian firms to rely further on borrowings from the international markets.

7－3 Causes of the Crisis-Banking Sector Problems-(4)

(1) Problems of the Banking Sector-Accumulation of Non-Performing Assets-

The financial deregulation policies introduced in 1984 and 1988 have accelerated development of the Indonesian financial sector(5). At the same time, rapid financial development and sharp increase in commercial banks' credits in the 1990s resulted in an increase in non-performing assets and that weakened the baking sector. The weak banking sector is one of the major causes of the current crisis. This section discusses the mechanism of accumulating non-performing assets in the banking sector.

Over the last decade, Indonesia has recorded remarkable economic development and shown rapid financial deepening. This is also the process of transforming the Indonesian economy from a government-led and traditional family group economy to a modern market economy. However, all factors involved in this process do not necessarily develop consistently and at the same speed.

Financial transactions are bound to the existing financial institutions and institutional settings (e.g. legal system). Community traditions and social customs also affect the players in the markets. Under these circumstances, financial deregulation and integration accelerated speed of imports of new financial products from the international financial markets without developing social and institutional factors. These inconsistencies among the modern market mechanism, financial institution, and traditional social behavior have caused an increase of non-performing assets in the banking sectors.

(2) Structure and Behaviour of State Owned Banks

Figure 7 — 1 shows the structure and behavior of state owned banks. This explains the typical mechanism of accumulating non-performing assets of the state owned banks.

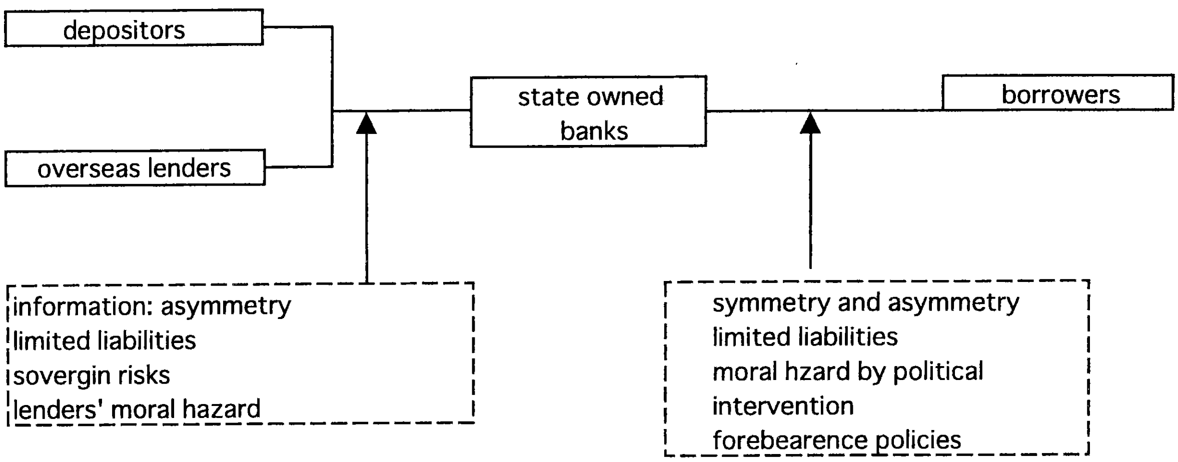

Figure 7 — 1 Mechanism of Accumulation on Non-Performing Assets State Owned Banks (classical moral hazard)

Although the financial deregulation policies were introduced in 1980s, the management of state owned banks and, particularly, the typical behavior of senior managers and borrowers (including powerful politician) remained without major change.

The Government appoints senior management of the state owned banks, and some of them have once held or even are currently holding posts in the Government offices or the Central Bank. Government guidance and instruction strongly affect management strategy. The banks decisions are often made from a political point of view, which may contradict the commercial and the financial discipline. Under this situation, the most important factors affecting the decision of the managers is to know the intentions of the Government and the politicians, rather than to develop financial intermediation including credit analysis, which is a major banking function. Such attitude of banks, without sufficient credit analysis, tends to increase non-performing loans. When problem loans emerge and payment arrears start to take place, the bank managers incline to hide them by rolling them over or by extending new loans. This is a typical "forbearance policy". This mechanism encouraged the increase of non-performing loans further and aggravates the problems. The ministry of finance and the Central Bank are responsible for bank supervision. As the structure and behavior discussed above, the ministry of finance and the Central Bank have no incentives to develop and implement a better bank regulations and supervision. Even though there were BIS rules existed in Indonesia, they have no incentives and intentions to follow them.

From the point of view of depositors and international lenders, state owned banks are perceived as sovereign risks, the safest of all. It is considered that there is a government safety net under them. A tacit understanding exists that the Government will not let the state owned banks go bankrupt. With such understanding depositors and lenders continued to provide funds into state owned banks without reviewing their risks, which led to the rapid expansion of the bank credits.

The above relationship among the bank managers, the depositor / international lenders, and the supervisors is called "moral hazard". As explained above, political intervention and bureaucratic behavior of the managers caused a sharp increase in non-performing assets during the late 1980s to 1990s in the state owned banks. This is a classical case of "governmental failure".

State owned banks' accumulation of non-performing assets has accelerated since 1990. Under financial deregulation, state owned banks must compete with other banks based on the market mechanism. Both state owned and private banks offered high interest rates to absorb domestic deposits, and they also increased overseas borrowings, and in turn increased their lending. As discussed earlier, the state banks behavior, which is characterized as "government failure" remains unchanged. Lending without proper credit analysis increased, and consequently, non-performing assets increased drastically. This is the major reason why non-performing assets accumulated in the state owned banks during the early stages of financial deregulation.

(3) Structure and Behavior of the Business Group Banks

In Indonesia, two types of bank exist, state owned banks and private banks. Most of the private banks belong to business groups such as overseas Chinese groups. Chinese business groups hold major share of the Indonesian private economy. Some big business groups already had their own banks before the financial deregulation, but many established after the financial deregulation policies introduced in 1980s.

Ownership and management are not clearly separated in the business group banks. A member of the owner family or a person close to it usually becomes the senior management of the bank. These business group banks absorb deposits from the public and lend them mainly to firms within the group.

In this case both lenders and borrowers belong to the same group and have a close relationship. It is not a modern market transaction with financial intermediation, but it is more like bilateral financing within a group, or even banks act as a conduit of financial resource for their group. The business group banks are not undertaking financial intermediary function, which is a core role of the modern banking system. Within the group, the information is symmetrical and perfect, however, for the concerned depositors, who are certainly outside the group, the information is asymmetrical (Figure 7 — 2).

Although non-performing asset ratio of private banks was relatively low compared to state owned banks, it increased after the financial deregulation throughout 1990s. Several private banks went bankrupt in the 1990s. (6) Most of them were group banks with a high concentration of loans to its own group. It appeared that rapid development of the private banks has also led to sharp concentration of the bank loans to its own group, which caused an increase in vulnerability of the private banks. Ultimate borrowers of the business group banks are family firms. Although they are formulated in as a modern limited company, the relationship between the bank and the group firms is unlimited. Since these banks are established to channel funds to group firms, the ratio of loans to group firms reached excessively high, often higher than the legal lending limit set by the Central Bank. However, there are number of ways to circumvent the prudential rules.

Within the business group, the firms hold a close relationship similar to a family structure where the members bear unlimited obligation (unlimited liabilities) to each

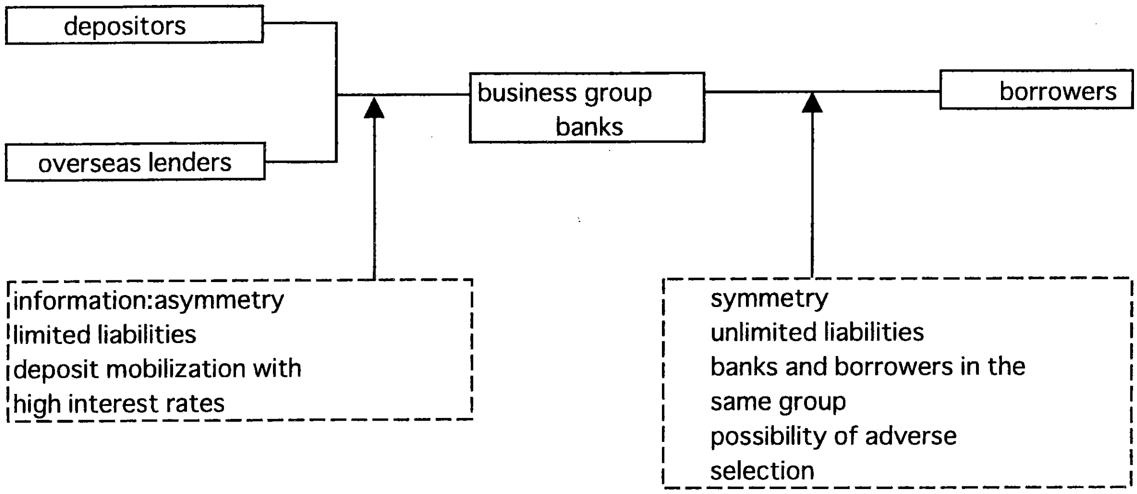

Figure 7 — 2 Mechanism of Accumulation of Non-Perfoming Assets Private Business group banks (mismatch between financial and social developments)

other, while the bank bears only limited liabilities to their depositors and international lenders since it is formed as a limited company. So that the private banks are only liable up to their capital vis-á-vis depositors and lenders, while they are unlimitedly liable vis-á-vis their borrowers (i.e. their group companies). It is natural for the group bank to give priority to the borrowers, the firms within the group, with which bank bears unlimited liability. When loans to group firms turned into trouble, the bank tended to continue lending by raising fund, even at the high cost, in order to rescue the troubled firm, with which the bank bears unlimited liabilities. This is called "adverse selection" of the banks. Once a member firm collapses, damages are serious and often lead to failure of the bank. However, the bank's liability is limited up to its own capital. From the point of view of the business group, newly created banks position is relatively weak and less important compare to the group firms, which are core of the group.

Within the business group, both lenders and borrowers share all of the business group's information. The information is symmetrical and perfect (Figure 7 — 2). On the other hand, the group does not disclose all of its information to outside, i.e., depositors and lenders. The information is asymmetrical and imperfect in this case. Having insufficient information, outside depositors do not know which bank is vulnerable or sound. They tend to deposit money in the banks offering higher interest rates. The inconsistencies between development of a modern financial markets and traditional social behavior cause moral hazard and thus cause the accumulation of non-performing assets in the business group banks.

7－4 Consequences of the Financial Crisis － What Happened to the Banking Sector? －

(1) What Happened to the Banking Sector?

There are two stages in the crisis in Indonesia. The first stage is the beginning of the crisis, between the summer of 1997 to the middle of 1998. The second stage is from the latter half of 1998 to today.

This section discusses what happened to the banking sector in the first stage. The next section discusses what happened to the banking system in the second stage, i.e., consequences of the crisis.

Since the financial crisis began in July 1997, in Indonesia massive capital outflows have been persistent pressure on rupiah exchange rate. In August 1997, the Government shifted from fixed to the floating exchange rate system. Towards the end of 1997, when the value of rupiah was depreciated more than half of the pre-crisis level, confidence crisis spread pervasively over the international markets as well as in the domestic markets. The result of this was a massive capital flight and the collapse of rupiah that led to the collapse of the Indonesian economic system including its banking system. Companies' owners and managers feared unprecedented fall of the exchange rate and claimed the situation as "force majeure." Moreover, they liquidated assets and fled the capital. Currency runs were amounted US$ 10 billion and rupiah rate was in free fall in late 1997 to mid 1998.

It is clear that severe currency runs triggered the financial crisis in Indonesia. What then happened to the banks? Were there bank runs? Looking at the consolidated commercial banks balance sheets, bank deposits continued to increase from 233 trillion rupiah in June 1997 to 236 trillion rupiah in December 1997, 342 trillion rupiah in June 1998 and 418 trillion rupiah in December 1998 (Table 7－3). There was no decline, rather sharp increase of the total bank deposits throughout the crisis period as far as nominal and consolidated basis. The announcement of the Government guarantee on all commercial banks liabilities including bank deposits in January 1998 appeared to be effective in preventing bank runs and systemic crisis even in this severity of the currency runs.

A question still remains, where the money for capital flights came from. It is necessary to have a more careful and detail reviews on the developments of the banks balance sheets. In order to understand real developments of the banks' balance sheets, it is nec-

Table 7 — 3 Commercial Banks Combined Balance Sheet

unit:trillion Rp

(1) June 1997

A			L
reserve	17	deposits	233
claims on private sec.	333	foreign acc.	56
foreign assets	18	foreign liabilities	33
claims on central gov.	1	others	65
others	57	equity	41
total	427	total	427

(2)December 1997

A			L
reserve	17	deposits	236
claims on private sec.	387	foreign acc.	91
foreign assets	47	foreign liabilities	70
claims on central gov.	1	others	85
others	77	equity	47
total	529	total	529

(3) June 1998

A			L
reserve	25	deposits	342
claims on private sec.	669	foreign acc.	178
foreign assets	188	foreign liabilities	189
claims on central gov.	1	others	251
others	133	equity	54
total	1,014	total	1,014

(4) Dec. 1998

A			L
reserve	34	deposits	418
claims on private sec.	513	foreign acc.	117
foreign assets	116	foreign liabilities	98
claims on central gov.	1	others	228
others	99	equity	-99
total	762	total	764

(5) June 1999

A			L
reserve	35	deposits	463
claims on private sec.	260	foreign acc.	108
foreign assets	81	foreign liabilities	73
claims on central gov.	92	others	132
others	93	equity	-216
total	560	total	560

(6) December 1999

A			L
reserve	42	deposits	474
claims on private sec.	226	foreign acc.	113
foreign assets	120	foreign liabilities	100
claims on central gov.	269	others	150
others	158	equity	-22
total	815	total	815

(7)June 2000

A			L
reserve	37	deposits	501
claims on private sec.	243	foreign acc.	125
foreign assets	94	foreign liabilities	81
claims on central gov.	373	others	155
others	123	equity	8
total	870	total	870

essary to look at the figures in the original currency, i.e., rupiah deposits and credits in terms of rupiah and US dollar deposits and credits in terms of US dollar. Because commercial banks balance sheets discussed above hide changes caused by the devaluation and shifts of funds within the commercial banks. Particularly, this is important because relatively large amount of deposits were denominated in US dollar, in Indonesia and exchange rate changes were so drastic during the course of the crisis.

Now we look into more detailed developments of banks fund and credits by currency and by category of banks (Figure 7 — 3, 7 — 4). The state banks' balance sheet reconfirms our earlier findings that there were no bank runs. Rupiah denominated funds (which include deposits and other funding in rupiah) continued to increase throughout the crisis period. US dollar denominated fund also increased from US$ 5.9 billion in June 1997, pre-crisis period to US$ 8.6 billion in December 1997, then down temporarily to US$ 6.3 billion in June 1998. The dollar fund of the state banks, although fluctuated, did not fall below the pre-crisis level.

Secondly, private banks' balance sheets show a decline in rupiah denominated deposits only temporarily from 147.4 trillion rupiah in December 1997 to 139.8 trillion rupiah in December 1998, then started to increase continuously. On the other hand, the US dollar funds of the private banks declined sharply from US$ 14.5 billion in June 1997 to US$ 3.8 billion in June 1998, almost one quarter of the pre-crisis level. The amount fell during the period was over US$ 10 billion. This is because (a) withdrawals of the dollar deposits and (b) repayments of the short term dollar funding without roll over. (Relative importance of the US dollar fund in the total funding, both rupiah and US dollar, amounted to around 20 to 30% in the private banks). The massive decline of the dollar funding hit the large and major private banks, which relied heavily on the dollar funding. This also includes banks connected to the President families and powerful politicians.

Next we should look at the credits side developments of the commercial banks. The state banks rupiah credits continued to increase until the end of 1998, well into the middle of the crisis, then declined sharply because of the writing off the non-performing loans. These developments can also apply to the state banks dollar denominated credits. On the other hand, private banks rupiah credits started to decline much earlier, during the fourth quarter of the 1997, then maintained its level until the end of 1998. After the end of 1998 they declined sharply, as results of the writing offs. The decline of the dollar credits of the private banks, which also started during the fourth quarter of 1997,

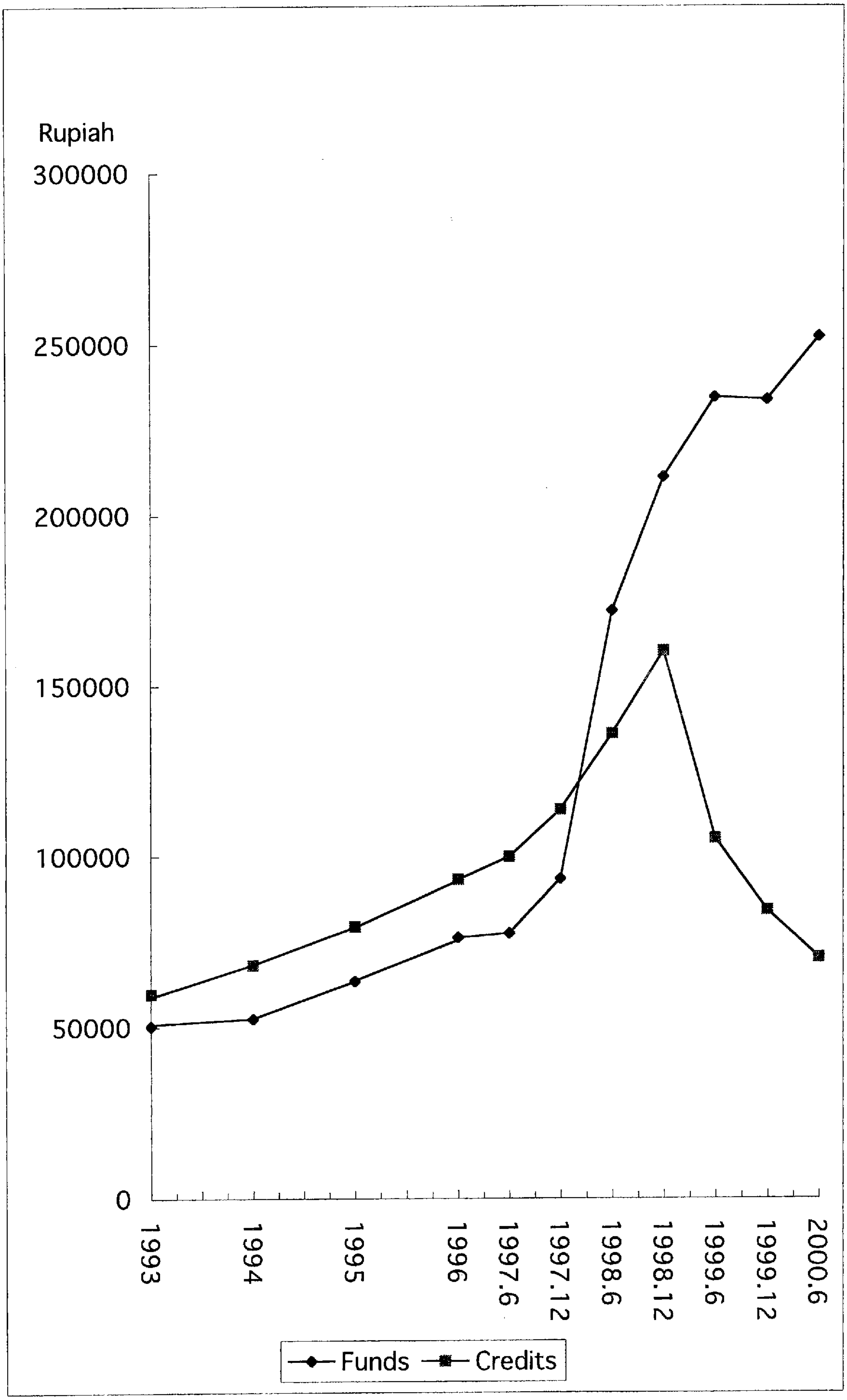

Figure 7 — 3.a Commercial Banks Outstanding Funds & Credits State Banks (Rupiah)

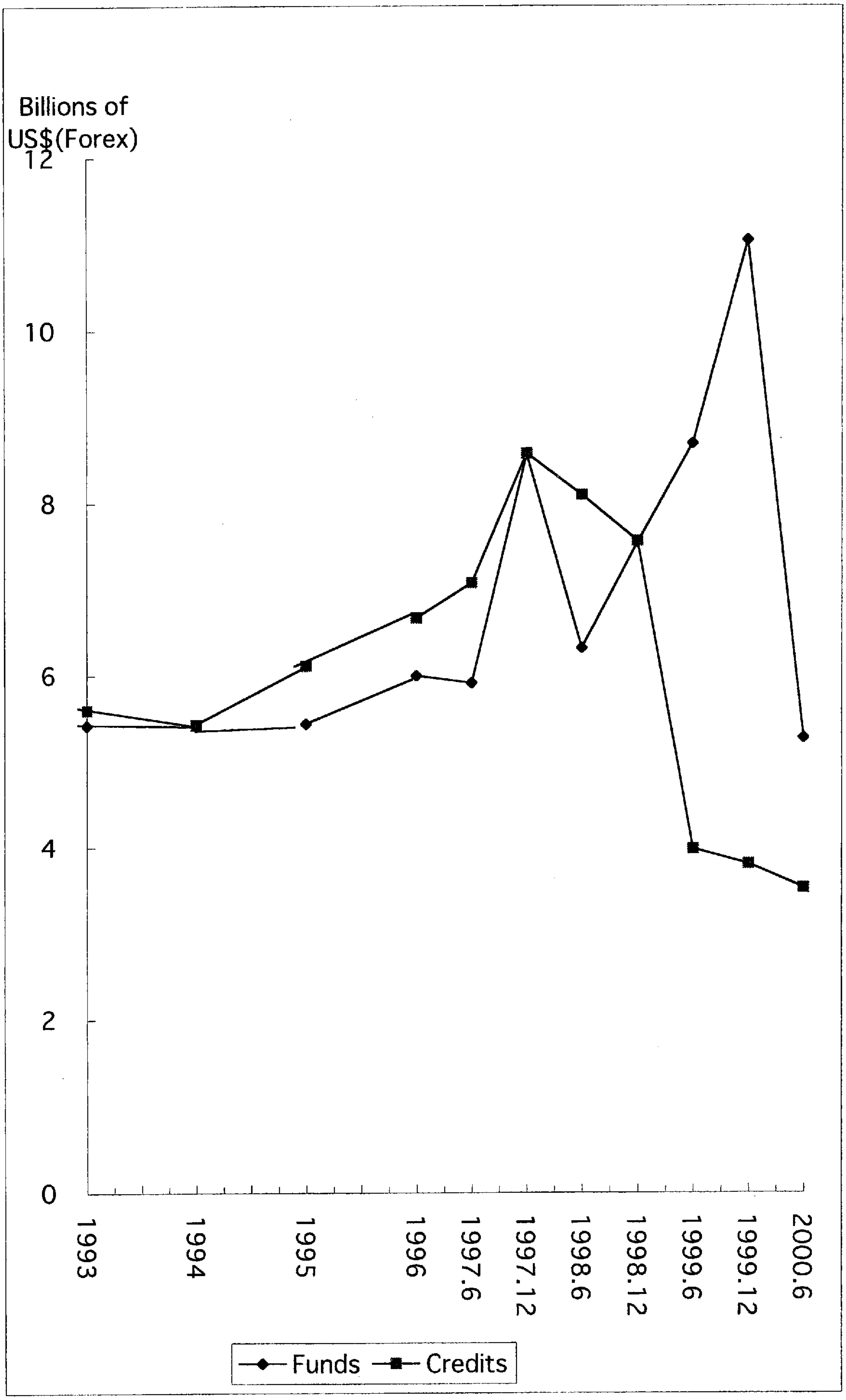

Figure 7 − 3.b Commercial Banks Outstanding Funds & Credits State Banks (US$)

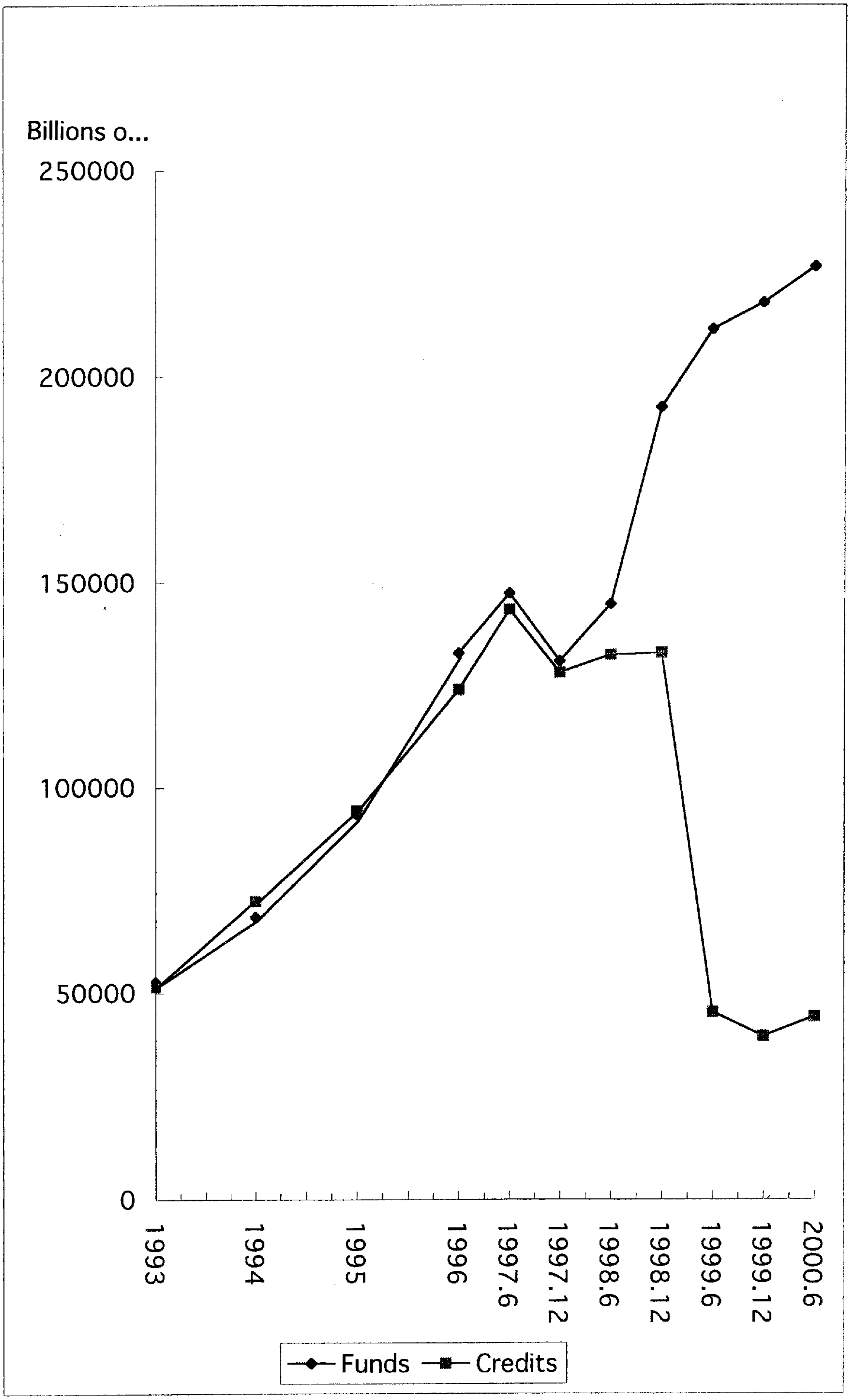

Figure 7 − 4.a Commercial Banks Outstanding Funds & Credits Private Banks (Rupiah)

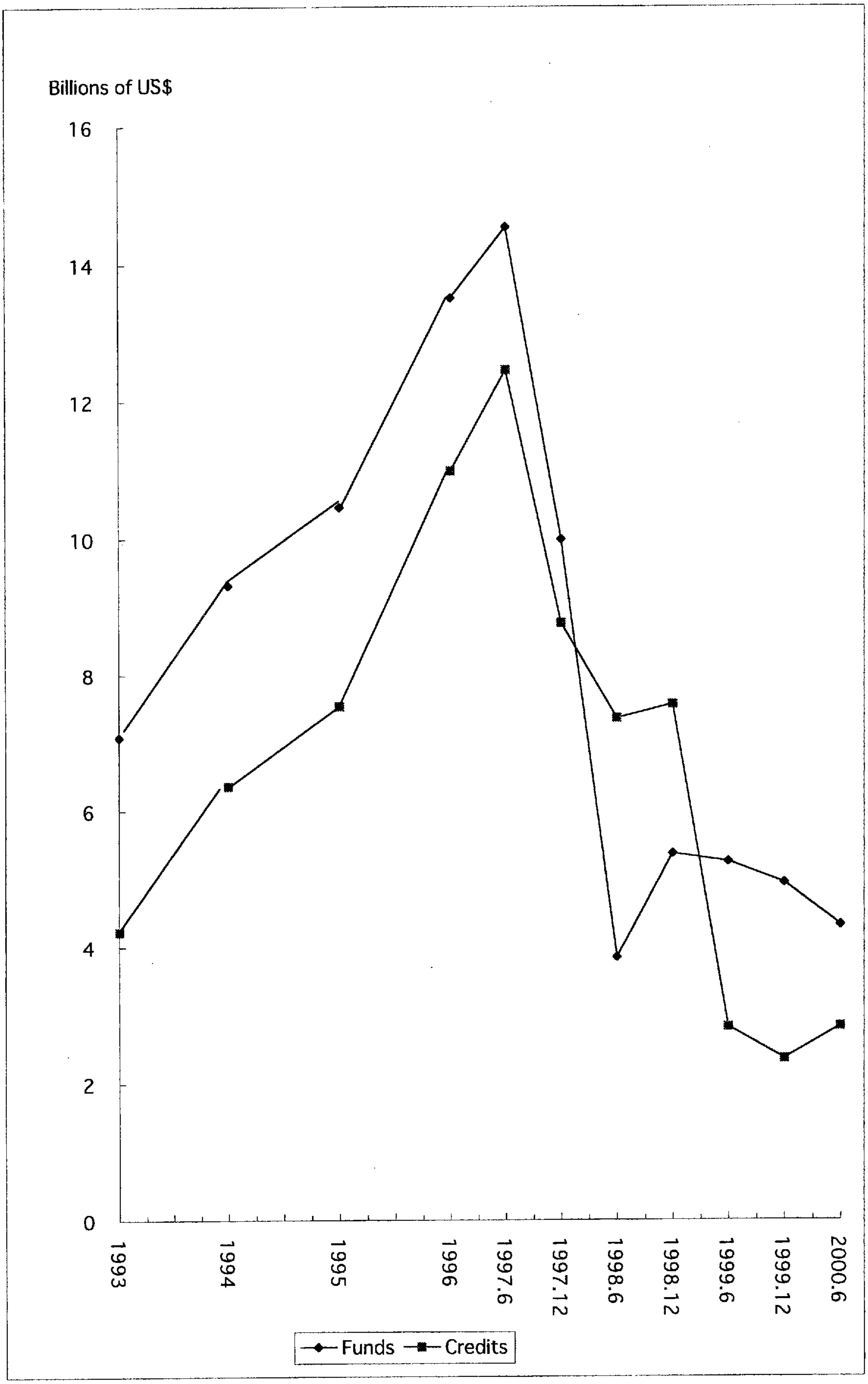

Figure 7 − 4.b Commercial Banks Outstanding Funds & Credits Private Banks (US$)

was the most drastic. This appeared to be matched with the sharp decline of dollar funding. As we see from the above, the decline in banks' credits after the end of 1998 was a result of writing off huge amount of non-performing loans. On the other hand the decline before the end of 1998 was due to either (a) actual repayments of the existing loans, or (b) voluntary writing off of the non-performing loans by banks (since the Government restructuring program was yet installed). For the first scenario (a), the borrowers must have repaid the dollar denominated credits to the private banks during the crisis. Was this really possible? Some borrowers were able to do so, but most of them were not. The second scenario (b), if this happened, the voluntary write offs must be associated with decline of the private banks' equity (assuming the banks follow the accounting rules). But, the sharp decline of the equity did not take place until 1999. So it is not clear exactly how the decline of the dollar deposits and the credits were financed, i.e., the source of the currency runs at the private banks.

In summary there was no clear bank runs in general. However, there were severe currency runs and flight to the quality, mainly by ethnic and political reasons. These factors triggered the runs mainly on the dollar deposits of the private banks.

(2) Banks Balance Sheets Problems

As a consequence of the massive currency runs rupiah exchange rates plunged. This turned almost all major Indonesian companies, which heavily relied on dollar financing, into severe balance sheets problems. Eventually the major companies were in default and banks non-performing loans increased sharply as discussed earlier. This was not apparent in the balance sheets figures until early 1999, when the Government started to take over troubled banks and introduced the bank re-capitalization program. By this operation commercial banks wrote off more than half of their credits to the private sector. The state banks claims on the private sector fell from its peak of 260 trillion rupiah in June 1998 to 125 trillion rupiah in June 1999 and 1997 trillion rupiah in June 2000. The private banks claims on the private sector also fell from 269 trillion rupiah in June 1998 to 76 trillion rupiah in June 1999. In this process commercial banks equity declined to minus 216 trillion rupiah in June 1999 . The Government re-capitalization program financed such a large writing off. This program was financed thoroughly by issuing the Government bonds that in turn constitute new equity of the commercial banks. The amount of the Government bond issued for the operation reached over 600 trillion rupiah or around 60 % of GDP in 1999 (Table 7 — 3). This together with the Government external debt constitutes a serious burden to the Government budget for the next several years.

As discussed above commercial banks deposits have been increasing throughout the crisis period while claims on the private sector, major assets of the banks, declined to less than half of the pre-crisis level. As a result, major assets of the commercial banks are now in the form of the Government bonds, which earns relatively low returns. Currently the commercial banks are not functioning as financial intermediaries and suffering from losses. It is too early to expect that the commercial banks start functioning again and channeling fund for the economic recovery at this stage. In order to reactivate the banking sector, the capital bases of the banks need to be strengthened and the Government bonds held by the banking sector should be absorbed by the secondary markets.

7 — 5 Lessons from the Financial Crisis

(1) Causes of the Crisis

Massive capital inflows and outflows and weak banking system were two major causes of the Asian financial crisis. Heavy reliance on foreign capital made the Indonesian economy more vulnerable to the external shocks. The weak banking system did not only cause accumulation of bad and doubtful loans but also accelerated reliance on foreign capital of the major Indonesian companies. This is because the financial sector of Indonesia remained inefficient and only provides limited size of credits at high margin compare to those of the international financial markets. When Thai Baht devaluation took place and contagion hit Indonesian Rupiah, the balance sheet of the banks and their borrowers, which heavily relied on the foreign liabilities, were deteriorated. This led to sales of stocks and induced more currency runs and further balance sheet deteriorations. This is so called process of "self-fulfilling crisis."

The Indonesian banking sector was engaged with ''moral hazard'' and ''adverse selection'', which encouraged lending to politically connected projects and to the family group companies. These lending were undertaken not because bank managers and borrowers behave irrationally. They all behave rationally and compatible to their incentives. The banking sector problems were originated from the logical and incentive compatible behavior of the all players involved in, which were deeply rooted in its system and institutions.

The modern banking sector and international financial markets can channel fund from those who have saved and hold surplus to those need funds to engage in investment opportunities. In the process banks, as a financial intermediaries, play important role of transforming various risks through credit analysis by assessing the borrowers information and monitoring. However, in many developing countries, banks are not in position to analyze credit risks of the borrowers. Particularly the state owned banks are normally under the control of the Government and ordered by the Government and politicians to extend loans to politically connected projects. The state owned banks have no incentives to undertake credit analysis, which is a major role of the financial intermediaries.

Family business group traditionally relied internal financing, i.e., from family members and friends and repatriating funds once fled outside the country. When economic developments were accelerated in 1980s to 1990s, increasing financing need was not met by traditional internal sources. It required external financing, i.e. from modern banking sector and the international financial markets. When they shifted to modern banking system, there was asymmetry of information that encouraged moral hazard and adverse selections. Therefore, business group banks were not only capable but also not in the position to analyze and monitor the borrowers, because the borrowers were in much stronger and in core position within the group companies (this is a crucial difference from the Japanese main bank system).

When the crisis hit in the summer of 1997, currency runs took place. Everyone tried to convert rupiah assets to dollar assets. In September 1997 the Government decided to shift to the floating exchange rate system, then the exchange rate fell sharply. The foreign exchange markets dried up, almost no dollar was available in the markets. The short-term dollar credits were not available and roll over was stopped. Furthermore, sharp depreciation of the currency suddenly led to the balance sheet collapse of the major Indonesian companies, which relied heavily on the external borrowings. Since the balance sheet problems were so disastrous, those also hit banking sector and the result was collapse of whole banking system.

(2) Lessons from the Financial Crisis

1) Dangers of Dollarization:

Dollar is widely used in the South East Asia. Dollarization was even encouraged in some countries, because it can help maintaining financial resources within its economic system and avoiding capital flight as residents have an opportunity to hold dollar denominated deposits. Dollarization can also be seen as a means to impose fiscal discipline. On the other hand, dollarization causes serious negative impacts to the economy. It reduces effectiveness of the monetary policies and banking sector vulnerabilities as they expose to foreign currency liabilities. When the weak banking sector faces bank runs, which may lead to a systemic crisis of the economy, the central bank is not able to act as a lender of last resort. Since such central bank action leads to substantial reduction of the foreign exchange reserves.

Finally and more importantly, it should be reminded that dollarization is a consequence of loss of confidence on its currency, economic policy and the Government. The cause of the loss of confidence should be corrected otherwise any policy or rules would not be trusted and therefore not effective.

2) Danger of Foreign Currency Liabilities

It is interesting to note that the larger and stronger banks, which had an access to the international financial markets and relied more on the foreign liabilities, were hit much more seriously by the recent financial crisis. The larger banks funded in US dollar from the international financial markets at cheaper cost and lend both in domestic and foreign currencies. There was a currency mismatch on the banks balance sheets. In some countries banks are under control of the net open position and not able to expose currency risks more than certain level. In this case currency risks are transferred to the banks borrowers. Then even if there is no currency mismatch on the banks' balance sheets, banks' borrowers heavily relies on foreign currency borrowings, thus banks' non-performing loans increase inevitably. Full dollarization may reduce currency mismatch, however, there are always some sectors of people who do not have income streams in foreign currency, thus expose to the serious risk of devaluation.

3) Danger of Pegged Exchange Rates

While floating exchange rate regime is highly volatile, the pegged exchange rate can be successful in maintaining stability and control in inflation. The pegged exchange rate regime could also avoid pressures on appreciation of the currency when there is heavy capital inflow into the system, which may lead to appreciation of currency. Appreciation of the currency is particularly detrimental to the export oriented economic strategy. The pegged exchange rate system worked particularly well in 1980s to 1990s when US dollar was continuously depreciating. Without any announcement the exchange rates of the South East Asian countries were depreciated in real effective exchange rate basis. This was compatible to their export oriented strategy and enhanced foreign direct investments to these countries.

On the other hand the pegged exchange rate regime illustrate risks during the course of the Asian financial crisis. The pegged exchange rate system provides a more stable value of the currency, it may give investors a sense of low risk of exposing currency risks and encourage more speculative activities. Under the pegged system when the speculative attack occurs, monetary authorities are expected to intervene in the foreign exchange market and to try to maintain its currency value. This may at the end lead to much bigger and disruptive decline of the currency value.

4) Danger of Government Interventions

Problems of the state owned banks are characterized as a typical "government failure" which caused moral hazard of state owned banks. Although the Government deregulated the financial sector, powerful politicians, army and senior government officials continued to influence banks' credit decisions. These credits eventually became non-performing loans. The banking system and institutions and bank prudential rules should be changed in the way that they encourage banks' credit analysis, so that incentive compatible behavior of bankers and other players would leads to building sound and efficient financial sector.

Furthermore, when the market expects possible future government interventions, behavior of the market players could be distorted in one way or another. For example, if markets expect the Government is bound by "too big to fail" policies, state owned banks would be encouraged to involve high risk projects and lead to moral hazard. Or if market expect that the Government is bound by the pegged exchange rate or low interest rate policies, investors would be encouraged to take higher risks on exchange rates and interest rates.

5) Danger of Family Group Lending

Problems of the family group lending are that a) banks have no incentive to scrutinize loans to the group borrowers, and b) there are high risks of moral hazard and adverse selections. Family group banks have wide spread lending to the group companies. The legal lending limit can easily be surpassed by various financial techniques including loan through affiliated companies and loan swaps. There are clear evidences of violation of the legal lending limit. It is estimated, in average, that more than 60% of total lending of the private banks in Indonesia was to their own group companies. This suggests that when crisis happened, default of a group company triggers to mounted many other related non-performing loans.

7－6　Conclusion

If the financial deregulation policies led to massive capital inflows and outflows and weak banking system, should the financial deregulation policies be withheld or at least postponed until the real sectors are fully deregulated and developed? If massive capital inflows and weak banking system were the cause of the crises, should foreign capital be controlled and the stricter bank regulations and supervisions be introduced? Can these measures avoid the financial crises and lead to more stable and successful economic developments? Economists have been discussing these issues including the sequencing of the deregulation policies for some time. The sequencing issues should be addressed in more practical manner. For some countries the Government does not have a luxury of going through the sequence, particularly under the today's integrated international financial environment.

It is worth to reconsider some fundamental questions. If capital flows were controlled, probably there was less reliance on foreign capital and less vulnerability to the currency depreciation, therefore less balance sheet problems. Capital inflows, however, were the important source of financing economic development in the Southeast Asian countries. As we experienced during the last 20 to 30 years in South East Asian countries, capital inflows, which induced by high savings, were (and still are) the important source of financing high investments in the region. In Indonesia, overseas Chinese capital is always sensitive issue but necessary for economic developments. It seems, therefore, that the issue is not to control foreign capital, but how to manage capital flows and external indebtedness of the country.

Bank prudential regulations and supervision, even if existed, implementation was weak and not effective in containing non-performing loans. As discussed earlier, bank managers and borrowers all behaved compatible with their incentives based on the existing system. Then what would be appropriate policy prescriptions? It is necessary to change system and institutions, particularly ownership structure of the banks, so that the banks would be in position to analyze and to monitor the borrowers (not just a financial conduit for the group firms).

It is also not the question of whether the financial deregulation or control. It is clear that further financial reform and deregulation policies are necessary in Indonesia. But, new rules and its strict implementation are also necessary for the banking sector. The rules and development strategies for the banking sector should be based on country's development stage, social system and institutional settings. The financial system, institutions, and regulations must be compatible with country's social environments and economic structure.

Above experiences of the financial crisis in Indonesia and other Asian countries provide important lessons in formulating Lao's economic policy and strategy. However, it is important that Lao's government must formulate economic policy and strategy with its strong ownership in accordance with county's development stage, economic structure, social environment, and institutional settings.

Notes:

(1) See World Bank. 1997. Private Capital Flows to Developing Countries. Oxford: Oxford University Press.

(2) See Komatsu Masaaki. 1995, "Some Issues in Financial Sector under Financial Liberalization and Free Capital Flows: Case of Indonesia", in Ito, Kazuhisa edited, Reform and Internationalization of Developing Countries, February 1995, Tokyo: Institute of Developing Economies . (in Japanese)

(3) Domestic banks margin was calculated by following equation: Bank prime lending rate of the working capital minus average three month deposit rate. The data used here were based on Bank Indonesia "Indonesian Financial Statistics". The margin over LIBOR was based on the various issues of "International Financial Reviews".

(4) See Komatsu Masaaki. 1996, "Financial Development in Developing Countries", in Ishikawa, Shigeru edited, Appraisal of Policies for Development Cooperation, March 1996, Tokyo: Institute of Developing Economies. (in Japanese)

(5) In 1984, the Government introduced the first deregulation policy, under which all interest rates were freed completely. In 1988, the second financial deregulation policy was introduced and that lowered the entrance barrier to set up new banks.

(6) Bank Summa is a typical example of this case.