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

Phase 2 Executive Overview

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**Committee for the Planning and Investment Lao People's Democratic Republic
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FOREWORD

This cooperation program entitled "Macroeconomic Policy Support for Socio-Economic Development of the Lao PDR Phase 2" 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. Dr. Thongloun SISOULITH, President of the Committee for Planning and Investment 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. Dr. Thongloun SISOULITH and each Committee member for their close cooperation extended to the study, and to the officials concerned for their valuable opinions.

March 2005

Sadako OGATA
President
Japan International Cooperation Agency

PREFACE

It is a great honor for both of us to present the summary of Phase II of the Lao-Japan joint study on macroeconomic policy and development to the government and the people of Lao PDR, following “Alternative Way of Development in the Lao PDR,” the main report of Phase II of our joint study.

This paper is entitled “Challenges for Integration” mainly because the Phase II study emphasized the crucial importance of integration in the three fields of international economy, the domestic market and communication between government and the private sector. Through the two-year joint study, the Japanese and Lao sides were able to achieve the common understanding that integration in these three aspects is indispensable for the long-term target of realizing sustainable development in the coming two decades.

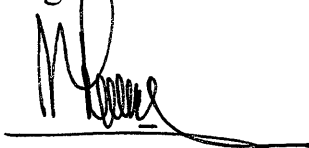
In particular, this study has emphasized that nowadays, in a time of globalization, careful and efficient utilization of unique characteristics in other words; comparative advantage of the Lao economy and resources is more meaningful and effective in the long run than the mere catching-up of per capita income. Following the main paper of the Phase II study, this paper also emphasizes that, under the strong pressure of regional and global competition, it is exceptionally important to find and promote a Lao way of development planning, with high respect for “thammasaat (nature)” and environment.

The study has demonstrated that the government should play 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 conditions in Lao PDR and to be able to integrate into global competition. At the same time, the government can administer market-friendly macroeconomic policies in order to maintain sound and stable conditions for the domestic economy. It is also imperative to design a long-term plan concerning public investment. Another important role of the government is to be active in the development of industries with potential comparative advantages as well as the development of a market economy as such. Furthermore, the government has a commitment to promote credible policies to gain the trust of the Lao people and the rest of the world in order to make them confident to implement government policies.

We hope that despite its somewhat limited scope, the findings and policy recommendations of the study will contribute to some extent to the formulation of the socio-economic development plan of Lao PDR.

We express our sincere gratitude to JICA for supporting our study entitled Macroeconomic Policy Support for the Socioeconomic Development in Lao PDR - Phase II for the two-year period from April 2003 to March 2005.

Thongloun Sisoulith



President
Committee for Planning and Investment

Yonosuke Hara



Chairman of the Japanese Committee
Professor, The University of Tokyo

Summary Papers of MAPS 2

“Challenge for Integration”

I. Challenge for Integration

I-1. Three Challenges of Lao Economy

This summary should start by confirming once again the basic challenges that Lao PDR is still facing. Lao PDR is undergoing a socioeconomic transition in which a planned economy is gradually being replaced by a market economy. Its main issues are to establish the legal rights of property-ownership, to liberalize the domestic economy extensively, to introduce laws and systems that are compatible to a market economy, to reform and privatize state-owned enterprises, to develop private enterprises and to reform monetary and fiscal systems. After the revolution in the 1975, Lao PDR had adopted a centrally-planned economy and state-owned enterprise system, even though it was implemented for only a short period. With the transition from these “old” systems to a market economy, some pressing issues have emerged.

Global integration requires a country to open its domestic economy to foreign countries in the aspects of trade, investment and finance, thereby inviting powerful external stimulation toward reform and growth. At the same time, it suggests that the country itself is incorporated into the global economic system of the times. Important policy decisions in this field are required in the content, speed, and order or sequence of participation in free trade; invitation of direct investment; and opening of foreign finances. During the period when Laos had a planned economy, the country was separated and isolated from the dynamic regional economic zone of East Asia, which undoubtedly was highly responsible for the lagging economy of Laos. Thus, global economic integration is an impending issue for the Lao economy.

Economic development denotes the dynamic process in which productivity income-increases and the economic structure is upgraded and diversified. This process is a classic economic issue, which confronts most, if not all, developing countries. It is typically the process of a transformation from a traditional agricultural society to a modern industrialized society. The matters of concern regarding economic development refer to the issues directly related to the well being of people such as population control, education and poverty reduction. They also refer to the issues related to economic development such as agricultural development, infrastructure improvements and issues on resource mobilization such as savings and investment, and labor movement between agriculture and industry. Furthermore, a key question concerns the development of a social stratum of industrialists who will be able to uphold industrialization. In Laos, the fundamental and long-term issue indeed

lies in development. Unless the prerequisites are satisfied, the transition towards a market economy and global economic integration will become distorted or unaccomplished.

Since the definition of integration has multidimensional implications, the following three challenges of regional economic integration, domestic market integration, and integration between the government and the private sector, can be summarized with the phrase, “challenges for integration.”

There is no doubt that the three processes are intricately intertwined. What roles should the government of Lao PDR play in these diverse circumstances? The first major role is to promote institutional reforms indispensable for the transition towards a market economy in monetary and financial aspects, and at the same time to administer market-friendly macro-economic policies to maintain a sound and stable domestic economy. 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 that includes public investment as well as to play an active role in establishing the development policies of various sectors from agriculture to manufacturing, especially for the development of industries with potential comparative advantages. This market-enhancing role is another important role of the government. What is most vital is that the government should commit to ensure all policies are credible towards both the Lao people and the outside world.

I-2. Basic problems of Laos's economy

The growth target set by the Lao government in its socio-economic strategy for 2020 seems to have encountered some difficulties. Of course, the policy target of the government, which aspires to have Lao PDR catch-up with its neighboring countries as soon as possible, is acceptable. However, in the reality of economic globalization, it is not only more meaningful but also efficient to effectively make careful use of their unique characteristics in economy and ecology, which are considered to be a comparative advantage for Laos.

The basic problems of Laos can be summarized as follows.

First, domestic economic regions are not unified, mainly due to the lack of infrastructure in transportation and communication and to the underdevelopment of the nation-wide market-economy. Lao PDR is a nation that is topographically segmented, and many regions are still in a stage of subsistence economy that is not adequately incorporated into a 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 a sparsely populated nation, although the population is growing rapidly. As a result, labor is not an abundant resource. Therefore, because the level of wages is not significantly lower than the neighboring countries such as Vietnam, Cambodia, Myanmar and China, it is a very crucial fact that any strategy based upon the utilization of abundant labor is not suitable to Lao PDR,

at least for the coming decade.

Third, the composition of the population is skewed as there is a high proportion of children, reflecting a high population growth rate. On the other hand, since the literacy rate of the population still remains low, human resources are not amply available to uphold the activity of a market economy. Additionally, Lao PDR is a multi-ethnic nation with a number of small ethnic groups, which is another factor that may hamper the unification of its domestic market.

Accordingly, the most fundamental challenge of the Lao economy does not lie in its transition from a socialistic system to a market economy, even though several negative legacies of the old system still remain. Rather, it is the very issue of development in which its domestic economy either grows from a subsistence economy, or shifts to one integrated market economy and away from segmented and divided regional markets. Plus, in promoting the long-term development of Laos, it is essential to improve physical infrastructure, such as a transportation system, to connect people that are sporadically inhabited. It is also imperative to enhance the quality of human resources by expanding primary education and strengthening the health and medical care system. Public investments should be concentrated on these aspects for the time being. And it is indispensable for the economic development of Laos to take the course in which people living in diverse ecosystems are accommodated gradually to a market economy, while taking environmental conservation into serious consideration. In any event, it should be emphasized that Laos is faced with the challenge of development that is more difficult than the transition from a planned economy to a market economy.

I-3. Participation in Regional Economic Networks

Lao PDR has obtained an opportunity to participate in a dynamic economic network surrounding Asia with its accession into ASEAN. It can now introduce capital from the global market; at the same time, it has made it easier to receive technical transfers from foreign countries. Moreover, participation into ASEAN enables Laos to join global markets. Therefore, it can be said that the first condition has been fulfilled for the integration of Laos into the global economy. This has been proven by the case of the 1990s when the inflow of direct investment from the surrounding countries, particularly Thailand, brought about the export-oriented production of motor-bicycle assembly as well as the export-oriented garment industry in Laos.

It is especially of great importance that Lao PDR has paved the way for receiving cooperation from the international society towards the development of the entire Indochina Peninsula with its reinstatement as a formal member of international society. Of particular significance is that Laos is now able to avail itself to the Greater Mekong sub-region development plan. In the plan, Laos, which is located in the center of the Indochina Peninsula or so-called "land-bridge," is positioned as an important traffic point from every direction in the region. More specifically, Lao PDR can now be more readily provided with loans and technical assistance from the Asian Development Bank and

other organizations for its infrastructure improvements such as national highways No. 9 and No. 13.

However, at the same time, we cannot downplay the fact that Lao PDR has many powerful competitors. In addition, we should not disregard the fact that its participation in the ASEAN Free Trade Area (AFTA) has remarkably shortened the remaining preparation time of its integration into the global market. Lao PDR faces an extremely difficult constraint upon its ability to develop several industries on par with the competitive level of international and regional markets by the year 2008, when in principle its tariffs must be lowered to the range of 0-5% for all imported commodities.

Nevertheless, it is also true that the unruly economic liberalization in the boundary area and the progress of the transition to a market economy already has Lao PDR participating in the Asian network. There is serious concern that Lao PDR seems to be easily influenced by the economic fluctuations of the surrounding nations. For example, the probability that a crisis can seriously affect Laos has already been concretely demonstrated by the currency crisis of 1997. At that time, the garment industry of Laos was dealt with a great blow that was caused by the decrease of exports to Thailand and the increase of the import costs of raw materials from Thailand.

Undoubtedly, Laos is now confronted with substantial difficulties in regards to diverse aspects stemming from its participation in the Asian network. It is necessary to carefully prepare participation into AFTA. Even though the initial cost of joining AFTA is a considerably large amount to Lao PDR, it is apparent that there are no effective development strategies other than accelerating its participation into the Asian network and overcoming the difficulties one by one.

Beyond AFTA, Lao PDR should reform its domestic economic policies and institutions towards being compatible to ASEAN-China FTA and ASEAN-Japan Economic Partnership Agreements, mainly through identifying the industries and commodities that have high potential for international competitiveness.

I-4. Economic Regionalism in East and Southeast Asia

Since the beginning of the 21st century, the world seems to be entering into more agreements of economic regionalism. Following the birth of the European Union and the establishment of the North American Free Trade Agreement (NAFTA), various kinds of regional economic plans and arrangements have started and been accelerated in South America, Central Asia and East Asia. These regional economic plans are not only limited to the reduction and elimination of tariffs on merchandise trade, but also include the harmonization of domestic economic systems and institutions, which go beyond simple free trade agreements (FTAs).

The movement toward concluding bilateral FTAs are now ongoing in East and Southeast Asia. This region has begun talking about establishing wider-based FTAs among China, Japan, South Korea, Taiwan and the members of ASEAN, thereby lessening existing distortions in the trade of goods and services throughout the whole region. During the final quarter of the 20th century,

economic interdependence among East Asian countries has deepened greatly. The current focus on East Asian FTAs actually represents the drive to give legal authorization to the de facto regional integration that has emerged as a result of market forces.

The reduction or elimination of tariffs within FTAs will result in an expansion of trade volume, especially in the products with high tariffs and non-tariff barriers. This is the most direct economic effect expected from a regional trade pact. Moreover, for the purpose of avoiding the exhausted issue of “country of origin,” which is a certificate requirement regarding whether goods are produced in the FTA participating countries, the FTAs will be necessary to evolve into customs unions by leveling tariff rates to the same lowest rate in all the participating countries.

Of course, lower tariffs will introduce difficult tasks for many East and Southeast Asian countries to cope with the adjustment costs of reallocating domestic resources, owing to the incoming foreign goods and services. For example, in Japan the agricultural sector presents the biggest hurdle to trade liberalization, but for other East Asian countries the costs of adjustment in the manufacturing and service sectors will also be considerable. In spite of this, countries like Thailand are now actively pushing for a regional free trade regime. The biggest motivation is to promote the inflow of foreign direct investments. A free trade arrangement means a larger potential market for locally produced goods, and this allows manufacturers to gain economies of scale and to realize the spatial concentration of promising industries. By encouraging this sort of dynamic development, the establishment of a free trade area can lead to an increased inflow of foreign direct investments. Considered to be the key to their economic progress, many East Asian countries have become enthusiastic for the concept of FTAs.

In order to meet these expectations, any East Asian economic pacts should provide not only for the free movement of goods and services, but also for a harmonization of investment rules, including the stipulation concerning the national treatment of foreign investors. In tandem with this, it is also necessary to further relax controls on the mobility of people so as to achieve greater efficiency in the interregional allocation of skilled human resources.

The harmonization of foreign exchange rate policies among the countries in East Asia will also be of the utmost importance. Now, money and financial capital flows freely around the world, and exchange rates are determined not by the balance of commodity trade but by international financial transactions. In this way, it should not be neglected that fluctuations in exchange rates often distort the effects of tariff elimination.

What is needed in the East and Southeast Asian countries is probably to adopt an exchange rate regime that relates their national currencies to the major currencies’ basket—the dollar, yen and euro. If they all adopted such a regime, their currencies would stabilize against each other, and this would both enhance the efficiency of production and the marketing of commodities. If the share of the yen in this basket were set at a high level, the exchange rates between Japan and other Asian countries’

currencies would also stabilize. It can be expected that this regime would give a major boost to the formation of a regional capital market. Thus for any regional economic pact to achieve its true potential, it will not be enough merely to remove barriers to the movement of goods and services within the region. It should be essential for the countries involved to coordinate their economic policies concerning such issues as foreign exchange rate and monetary policies.

Now in East Asia, plans such as building the Southeast Asian Economic Community have been proposed to establish a regional economic community. Though the definition of an economic community is not yet clear, the necessary steps from a free trade pact to an economic community should rest in the participating countries' ability to adjust and enhance their economic systems and institutions so as to benefit all of the member countries. Needless to say, establishing this kind of economic community will be a very difficult endeavor in East and Southeast Asia, because the region is composed not only of countries at different stages of development, but also of diverse political and economic systems and institutions. Even though the task will be quite difficult to attain, Lao PDR should carefully prepare the basic conditions for participating within the regional economic communities.

I-5. Market-friendly Macro Economic Policies

The final goal in the present development plan of Laos is to discard its status as a least-developed country by the year 2020. To that end, around 7% of GDP growth is set as the target. In order for this growth target to materialize, Lao PDR is required to have investments at the ratio of 25-30% vis-à-vis the gross domestic product. The incremental capital-output ratio (ICOR) is estimated at around 4. This assumption is not unrealistic because Laos still remains at a stage where it unquestionably needs public investments for its infrastructure. The question remains whether enough capital can be supplied to satisfy the requirement for such a massive amount of investment that is so disproportionate to its domestic economy. Briefly stated, it will be absolutely necessary to finance the greater portion of the required investment through foreign aid and foreign private investment including BOT.

Indeed, foreign aid has been increasingly expanding to the extent that it composed approximately 55% of Laos's public investment in FY2001-02. It is based upon the premise that Laos is very important as the land bridge of the Indochina Peninsula that donor countries or donor organizations provide their foreign aid. The main concern here is the capacity of the Lao PDR government to efficiently absorb such foreign aid. The rapid and continuous enlargement of public investment financed by foreign assistance requires an increase of current expenditure by the central and local governments.

The basic problem, then, lies in the possibility of 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 to increase the rate of private savings. Consequently, it is vital that domestic savings flow smoothly and effectively into the production sector through the upgraded intermediation function, of absorbing the deposits and extending the credits, and of the domestic banking sector. The mechanism of financial intermediation should be institutionally strengthened.

The government's budget revenues still remain less than 15% of the GDP. It is mainly because of the difficulties in tax collection and the enlargement of the expenditures caused by an increased number of development projects, that fiscal matters are quite serious in Laos. Therefore, it is urgent for Laos to overcome a shortfall of tax receipts caused by the existing inadequate tax regulations and taxation system. Lao PDR faces the serious dilemma of expanding the tax base without depending upon customs duties as well. If it fails to secure budget revenues, it will face another critical problem whereby budget deficits will expand and accelerate inflation.

The current account deficits that have reached roughly 15% of the GDP pose another serious problem. Under the present circumstances in which domestic savings cannot be efficiently mobilized, increased domestic investment will result in widening deficits in the balance-of-payments. Therefore, adequate precautions must be taken on the issue of foreign debt management. Because Lao PDR has no promising export industries other than electricity and lumber, should it become too dependent upon foreign resources, particularly official aid, the danger is that its foreign debt management would increasingly become strained.

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

II. Summary of Four Working Groups

II-1. Fiscal and Financial Policies

II-1-a. Fiscal Sector

A paper authored by the Japanese side discusses the problems associated with the decision-making process for public investment, which focuses on the public investment management system (lack of a unified system) and the public investment decision-making mechanism. In recent years, both the public investment management system and public investment decision-making mechanism have been changed as a result of the issuance of the Decree on Public Investment Plan (PIP) Management

by the Prime Minister's Office. As part of this process, the interface and coordination function for foreign aid has been transferred from the Committee of Planning and Investment (CPI) to the Department of International Cooperation of the Ministry of Foreign Affairs. The paper raises the question that unifying the management of public investment decision-making will be difficult under the new system because of Laos's high dependence on international aid in its public investment and development program. Namely, high dependence on international aid tends to increase the likelihood of foreign aid projects being favored in the prioritization of public investment projects, thus this could give rise to a conflict between the goals of the development program and the choice of individual projects. For this reason, close coordination and cooperation is required among all government bodies involved in public investment, including the Prime Minister's Office, the Committee of Planning and Investment, the Policy Research Department and Department of External Finance Relations of the Ministry of Finance, and the Department of International Cooperation of the Ministry of Foreign Affairs. It is also important that these organizations develop a check-and-balance mechanism with one another. In the medium- to long-term, foreign aid projects will entail maintenance and management costs, which thus intensify fiscal expenditures in the future. For this reason, a decision on foreign aid projects needs to be made after careful consideration of their affordability in terms of future costs and fiscal revenues.

A Lao side paper discusses the procurement of development funds through the issuance of government securities. It first explains Laos's fiscal and financial situation to help policymakers understand the economic reality, and it then goes on to a discussion about the development of the government securities markets and the procurement of development funds through it. The paper focuses on the explanation of economic development and trends in monetary policy and fiscal policy, and they explain treasury bills (T-bills) and Bank of Laos bills (BOL bills), as well as describing the status of the issuance of those bills. On the other hand, it is also dedicated to the discussion of issues such as the procurement of development funds through the issuance of government securities and the relationship between the development of government securities markets and monetary policy.

Furthermore, it identifies several conditions essential for the development of government securities markets. Based on those arguments, it provides policy recommendations on the following matters: (1) How the financial sector can be strengthened, (2) How public confidence in the banking system and Lao currency can be enhanced, (3) How the institutional arrangements for the foreign exchange rate can be strengthened, (4) How the coordination among the BOL, MOF and Committee for Planning and Investment (CPI) can be strengthened, (5) How the MOF can be strengthened and (6) What can be done to develop the primary and secondary markets for government securities.

II-1-b. Financial Sector

Another Japanese paper provides advice on the proposed establishment of a development finance institution (DFI) with reviews on the progress of financial reforms in Laos. Many banks in Lao PDR are marred by an excess debt problem, and the banking system is currently undergoing a rehabilitation process under the supervision of the Bank of Laos and ADB advisers. According to a recent balance sheet of the banking sector, while the loan balance has been slow to grow, the deposits have been steadily increasing. This has resulted in a fall in the deposit-to-loan ratio and indicates that banks are failing to fulfill their financial intermediary function. The paper also points to signs of a credit crunch on the grounds that the banks have held back credits, even from sound borrowers.

On the contrary, the Lao side has expressed a strong desire for an establishment of a new DFI. In this regard, the paper provides the following advice: (1) Appropriate assessment of credit risk. Namely, there is a need to clearly distinguish between projects amenable to commercial financing and public financing; (2) Maintenance of the independent status and autonomy in loan decision-making; (3) Mobilization of domestic savings as the first measure to raise capital for loans. Fostering of healthy financial institutions which are capable of fulfilling their financial intermediary function is a precondition for the effective utilization of facilities such as two-step loans from foreign aid organizations; (4) Importance of learning from the experiences of Vietnam and other countries that have gone through the same problems—including the development of an institutional framework—as well as seeking technical cooperation from overseas donor organizations in terms of human resources development in the financial sector; and (5) Need to follow the proper procedure for the establishment of a DFI which is in line with the stabilization of the macroeconomic environment.

Another paper prepared by the Lao side's Finance Working Group examines the establishment of a development finance institution (DFI). Firstly, it argues that the establishment of a DFI is urgently needed due to the following reasons. These are: (1) The existing Agriculture Promotion Bank (APB) is restructured as part of the banking system reform, and is expected to become a commercial bank in the future. Thus, it gives rise to a need for an organization that will take over the function of providing policy-based loans to the poor; (2) At present, commercial banks are very cautious of extending loans amid a general credit restraint trend where numerous would-be borrowers are without access to loans; (3) Large untapped demands for long-term funds, particularly from state-owned enterprises (SOEs) and small and medium enterprises (SMEs) exist; (4) Policy-based loans are essential to foster a private sector, particularly to promote the growth of priority development areas and SMEs. The paper goes on to discuss matters that need to be considered in the establishment of the proposed DFI on the basis of Japan's experience (Development Bank of Japan); for example, the board structure for ensuring good corporate governance. In relation to the demand

side of policy-based loans, it examines sector-by-sector lending priorities. Finally, the paper suggests there is a need for further debate on the conditions in the establishment of a DFI in today's Laos.

II-1-c. Fiscal and Financial Sectors

A Japanese side's paper briefly reviews the structural characteristics of the fiscal and financial sectors and discusses major issues arising from them. In Lao PDR, problems with both the banking sector and the public finance sector are intertwined. The massive bad debts that the banking sector is saddled with cannot simply be blamed on the lack of risk assessment capabilities of the banks. Rather, the largest contributing factor is the government's chronic fiscal deficit and its financing by the banking sector. Without a reform of the fiscal structure and the breaking of the vicious cycle of fiscal deficit and bailout by banks, it will be impossible to restore the health of the banking sector. In other words, without fiscal sector reform, the banking sector will not be able to finance economic growth. This is the real reason why the Lao government proposed the establishment of a new DFI. This means that the establishment of a DFI will not solve the problem; the fundamental solution only rests in a reform of the fiscal sector. What, then, are the key issues of fiscal sector reform? As there are quantitative limits to foreign aid funds, any residual fiscal deficit must be financed with domestic savings. Moreover, government debt that accumulates through fiscal deficits must be kept to a manageable level. The size of the outstanding government debt had already reached 70% of the GDP by 2002. This means that the government must cut its fiscal deficit and keep it low. The sustainable level of government debt and chronic fiscal deficit pose severe constraints for Laos and there are only limited options available to overcome them.

II-1-d. Microfinance

A paper written by the Japanese side investigates Saving Groups and Credit Markets in rural Laos. In the villages, various organizations are moving ahead and shaping the microfinance system. Of these projects, the largest one is FIAM, a Thai NGO. However, in any discussion of microfinance, it is necessary to make a distinction between the targeting-the-poor type of finance and the outreach type, which aims to provide credit to as many people as possible. It is also necessary to discuss whether the lending funds are reliant on savings or on external (aid) funds. The Grameen Bank of Bangladesh provides targeting-the-poor finance that is dependent on external funds. In contrast, FIAM saving groups provide outreach-type finance, and are dependent on internal funds (i.e., members' savings). This marks a difference with the Grameen Bank in that it can be expected that the savings of the rural villages will be mobilized in the future.

In the paper, an interview survey was carried out in a total of 837 households of six villages in the special municipality of Vientiane and in Luang Namtha Province. Those villages are either relatively more prosperous or poorer than other villages.

The following are the major results obtained.

The amount of savings is rapidly increasing in the saving groups. There is a surplus of savings in the rural villages, and this means that the saving groups have been successful in getting people to save as a financial asset, not only in the form of domestic animals or gold. Since savings are a financial asset that can be used to mobilize assets, this is effective in raising the economic welfare of the village.

The saving groups are an alternative way of informal borrowing and lending. Money lending is not common, because borrowing and lending between relatives is the main part of informal finance. Even some land-owning households purchase rice prior to the rice harvest. For these households, the saving groups make it possible to reduce seasonal poverty. The saving groups also fulfill a role in the purchase of consumer durable goods and in the introduction of new farming techniques. The monetary earnings of farmers vary and the monetary income from farming itself is not large, but income generated by activities in non-farm household accounts for a larger proportion. Typically, the retail and trading of weaving and the capital demand for these activities are also fulfilled with the saving groups.

Taken overall, the role played by the saving groups can be highly evaluated. However, a problem has arisen in that the demand for loans is insufficient for the satisfactory growth of savings. Already in a number of saving groups, the amount required for loans is less than the amount saved. Thus, the saving groups are unable to realize sufficient earnings from interest. In a saving group system where interest is apportioned according to the amount saved, this diminishes the members' motivation to save.

As a measure to counter this, the following points will be made. A possibility of commercial activities in the villages, like the Chinese township and village industry, should be looked into. For example, one village in Thailand has used its surplus savings to build a thread-spinning factory. Therefore, consideration should be given to the use of the savings to build village infrastructure. But, the saving groups are restricted to providing credit only in the village. So it would be worth considering loan provisions to saving groups in other villages that have a shortfall of funds. This is a plan that CODI of Thailand is trying out in Laos. If it is successful, there is the prospect that village saving groups will eventually develop into regional banks. When this happens, then legal preparations are necessary. Further, it is required to pursue the possibility of having the savings mobilized from the rural villages being tied into a larger financial market. For example, in Japan, the savings mobilized from rural villages are used for macro-economic development in the process of industrialization and infrastructure improvement. In order to realize it, a reform of the present dysfunctional banking system is essential. Unless such reform is proposed, there is the danger that the measures mentioned above will push the saving groups into decline.

II-2. Development Policies of SMEs

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

Instead, the strategies that effectively utilize the existing local resources and techniques will be the most effective for Lao industrialization. One of promising examples is the rural hand-weaving industry 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- and medium-sized industries in various fields.

The development of industries might be possible in conjunction with the development of existing companies, especially small and medium enterprises. These companies are established and developed primarily by entrepreneurs. Therefore, in order to plan a development scenario of the Lao economy, it is necessary to examine what kind of obstacles are faced by entrepreneurs, companies, and industries, how they are trying to overcome those obstacles, and what type of policies are effective for supporting their efforts. Based on this standpoint, the Lao side members and the Japan side members of the SME Working Group cooperated in the task of interviews, questionnaire surveys and industry-specific surveys.

In the SME working group, an interview survey was done in 90 companies in Vientiane, Luangphabang and Savannakhet. The first paper analyzes the various routes in which entrepreneurs emerged in Laos. The paper comes to the principal conclusion that “entrepreneurs are born from their experiences as *talat* (market) merchants or craftsmen in small local factories. To develop their companies thereafter, entrepreneurs themselves are required to devote steady efforts for the ‘discovery of the market’ and the ‘mobilization of technology’ so that they may respond appropriately to changes in the business environment.”

Two other papers analyze the results of 173 questionnaires collected in Vientiane city. It emphasizes the significance of traditional “*kha patcham*” relationships and the importance of a stable macro economy to realize those relationships. It states that “micro-entrepreneurs are suffering from the instability of business circumstances and capital shortage,” but “they cope with these difficulties by establishing client relationships with both suppliers and customers.”

The third paper presents the analysis as follows, based on interviews with distribution companies and observations of small retail businesses in the *talat*. “The distribution system serves basically as an infrastructure for the marketing activities of uncompetitive domestic manufacturers of consumable goods. But the present distribution system in Laos is not capable of responding to diverse consumer demands.” It then stresses the importance of raising the overall level of domestic retail businesses and of developing promising businessmen in order to give domestic manufacturers

sufficient competitiveness against the inflow of overseas consumer goods.

The fourth analyzes the on-site survey results of the wood processing industry and presents policy proposals, and the other two papers focus on the agro food processing industry and the silk and cotton industry, respectively. Regarding these papers, the following three points should be emphasized.

Firstly, on-site visits by the administrative officers are necessary in the efforts to grasp and discuss the reality of a Lao industry, because the findings obtained are extremely important for formulating realistic policies. In MAPS 2, this effort was carried out in the three major industries as part of the activities of the SME Working Group. Secondly, these papers call attention to the need for information sharing between the government and industries. It also describes the importance of strengthening the functions of the chamber of commerce and industry as a measure to promote information sharing as well. The third specified point is the necessity of coordination among the policies of different government ministries, and ensuring transparency of the policy-making process. For example, as mentioned in the fourth paper, the business activity of a single industry relates to a number of policies made by different ministries. Without coordinating those policies, a single ministry's effort to promote the industry will only prove ineffective. A clear example of this was obtained from interviews of the recent on-site surveys, which are expected to serve as a significant reference in examining policy-making frameworks in the future.

The final paper is on the regional study of SME development in the central area of Savannakhet province, which is an analysis based on statistical surveys and results of 109 questionnaires. According to this, various SMEs have also developed by making use of previous entrepreneurs' experiences in commercial business or small local factories. But it is clear that the difficulty in acquiring technology and the shortage of working capital are posing obstacles to their future development.

During the two years of this project, the motto of the SME Working Group was, "First, let us see the sites, and then discuss the issues based on the facts." The new industrial promotion policy of modern Japan was also formulated based on the results of a site-survey on the industries throughout Japan, which was completed by Mr. Masana Maeda, a high-ranking official of the Ministry of Agriculture and Commerce, and his colleagues. The SME Working Group set out to follow in Mr. Maeda's footsteps.

A policy formulated under completely different circumstances should not be transplanted directly to another occasion, because it could be harmful. On the other hand, transference of a policy-making concept could be possible and beneficial to others. Anyway, the success or failure of our efforts rests on whether SME policies in Lao PDR are formulated and implemented in accordance to the reality.

II-3. Agriculture and Rural Development Working Group

Agricultural and rural development is undoubtedly the basis of economic and social development of Lao PDR, because the majority of the population lives in rural areas and the agricultural and forestry sector still accounts for 50% of the GDP. However, although the agricultural sector of Lao PDR has shown remarkable growth even after the economic crisis in Southeast Asia, it still encounters considerable constraints on the development of agriculture under the circumstance of developing a market-oriented economy.

Therefore, the Agriculture and Rural Development Working Group of the MAPS 2, consisting of Japanese experts and Lao officials from NERI and the Ministry of Agriculture and Forestry, focused its activities on exploring possible ways for solving the constraints faced by the agricultural sectors. However, since the Group could not cover all the aspects related to agricultural and rural development, it was formed with a limited number of research teams for investigating some selected subjects such as export-oriented agricultural commodities, rural finance, the land-allocation program and agro-ecotourism.

In addition, in the course of implementing these group studies, one more subject was set as a supplementary study, i.e., a preliminary study on local products with a scope of collecting relevant information for promoting the One District One Product (ODOP) project. In this paper, the results obtained are compiled from these studies that were jointly conducted in various regions of Lao PDR mainly in 2003 and 2004.

II-3-a. Surveys on export-oriented agricultural commodities

The research team dealing with export-oriented agricultural commodities carried out the surveys by focusing on some selected commodities, such as aromatic rice, yellow cattle and buffalo, maize, raw cotton and spun cotton, livestock fodder and textiles, in order to examine the international competitiveness of these commodities and to clarify the constraints on production and export expansion.

Aromatic rice

Regarding aromatic rice, the surveys were conducted in Savannakhet province and they revealed that the competitiveness of Lao aromatic rice was not necessarily weak in comparison with those in Thailand and Cambodia. And, in order to promote its export the surveys concluded that the present overvaluation of the exchange rate should be corrected and that more effective production systems including post-harvest processing should be introduced.

Livestock raising and feed industry

The surveys on the international competitiveness of yellow cattle and buffalo were also conducted

in Savannakhet province, where the largest number of cattle and buffalo are raised in Laos. Although the export of this livestock amounted to more than 200,000 heads, many of them are described in the research to have been exported through informal channels. As this fact indicates, Laos has a great potential to increase livestock exports. However, in order to materialize this potential, the surveys pointed out the need for employing the following strategies: 1) improvement of the productivity of grass cultivation and feeding techniques, and introduction of concentrated feed in the areas where the mixed-farming systems are adopted, 2) introduction and promotion of group rearing to establish large-scale beef enterprises in the hill and highland areas, 3) improvement of the institutional frameworks for preventing epidemics such as foot-and-mouth disease, 4) improvement of the quality of vaccines, and 5) abolishment of the export-licensing system and removal of the non-tariff import barriers in Thailand.

In relation to animal husbandry, the survey team conducted an investigation on the feed industry. A state-owned feed producing enterprise was established in 1982, and it was privatized in 1993. Even though the feed company uses local raw materials, it still imports raw materials mainly from abroad. The share of imported raw materials accounts for 30% in terms of quantity, but this shows a sharp contrast if compared with the share in terms of production cost, accounting for 70%. Despite the current situation, the production cost analysis estimates that the competitiveness of live fodder production is not low. However, it suggests that for further development to occur the following strategies should be put into practice: 1) to ensure a stable supply of raw materials such as maize and sugarcane by promoting contract cultivation and upgrading the shipping network, 2) to secure a supply of imported dried fish and nutritional supplements, and to work on quality improvement, and 3) to link the fodder industry to the developing beef cattle industry.

Maize production

Maize is also an important export-oriented crop in Laos. In fact, it has already been exported to a considerable extent to China and Thailand. Taking this situation into consideration, the surveys were conducted in three provinces—Luang Phabang, Xayaboury and Oudomxay—in order to understand the production systems, examine their sustainability, and analyze the impact of an increase in maize production on poverty alleviation and stabilization of shifting cultivation. Based on the comparative cost analyses, the crop was identified to be highly profitable and globally competitive.

However, in relation to the sustainability of its production, many constraints were pointed out such as a decrease of soil fertility, lack of market information, limited available lands for cultivation, and inadequate grain-quality control. In particular, as the case in Xayaboury indicates, an expansion of maize cultivation without using fertilizers brings about a serious decline of soil fertility and, as a consequence, it is suspected that further expansion will encroach on the protected forests. In order to sustain the present condition of production and export, the surveys conclude that the government

needs to pay more attention to providing market information and new technologies, and to introducing and extending alternative farming methods such as mixed cropping with beans.

Cotton production and textile industry

The surveys on cotton were conducted in both Luang Phabang and Savannakhet with the aim of elucidating the present situation of cotton production and proposing an outlook for the development of cotton production and export. Cotton cultivation in Laos showed a regional difference between northern and southern Laos. In the north, as a component of shifting cultivation, the cotton is grown on mountain slopes once a year in the rainy season; while in the south it is grown twice a year in the upland fields in the rainy season and on the inside of river banks in the dry season after the recession of river water. Since the demand for cotton production in Thailand far exceeds the supply, Lao cotton production has a potential to develop further as a means of increasing income in rural economies. Despite the drawback in terms of materials for a viable modern textile industry, Lao cotton with its short fiber length can still be used in medical supplies, hotel linens, textiles such as Oxford cloth, which makes it ideal for domestic import substitution. As local varieties such as *fai nyai* and *fai tun* have already been used for high-quality, commercialized and exportable traditional fabrics, further increase in export can be expected.

In relation to cotton production, silk and cotton weavers at Vientiane were investigated in order to examine the global competitiveness of hand-weaving industries. The analysis reveals that the hand-weaving industry has a potential to develop the export industry insofar as the weavers continue to use traditional materials and techniques, and suggests that the government should adopt the following policy supports in order to increase exports and domestic sales: 1) securing the raw materials, 2) establishing a brand and expanding sales channels, and 3) developing cooperation and collaboration between and among relevant government authorities and private agencies.

II-3-b. Surveys on rural finance

The research team dealing with rural finance conducted several case studies in northern, central and southern Laos in order to understand the function of the rural savings group (case study 1), to find the relationship between the transformation of agricultural practices and villagers' financial activities (case study 2), and to analyze the financial problems under the unstable market environment (case study 3).

Potentials for saving mobilization (case study 1)

The team conducted surveys in a fairly flat 147-household village in Vientiane Municipality that is centered on paddy-rice farming and alcohol breweries. It analyzed the village-level savings group that had been growing and developing rapidly since it was established in September 2000, and

investigated the potential for saving mobilization. Based on the results obtained, the team's paper noted that in the less than four years since the group's founding, they have successfully mobilized over 200 million kip (20 thousand dollars) in savings; that due to extremely high demand for loans in the village against this amount with a 4% monthly interest rate, all of the saved money had recently been loaned out until fairly recently, and only lately has there begun to be surplus funds available; that some sort of integration will be required as some villages' savings groups recently started to have surplus funds; and that there emerged a good opportunity for rural saving mobilization for the Lao government. The paper also discusses the drastic reduction in standing rice sales as a result of the introduction of the savings groups.

Expansion of maize cultivation and its impact on rural finance (case study 2)

The case study 2 was conducted at a 91-household village in Houn district in Oudomxay Province, which has engaged in slash-and-burn upland rice cultivation and livestock husbandry ever since it moved down from the mountains and was re-established in a valley in the latter half of the 1970s. Since 2000, the village began cultivating maize for export to China. The paper discusses how much the increased income from maize cultivation has affected the villagers' financial activities, including consumption, investment, savings and borrowing. Villagers, obtained a large amount of cash income from maize cultivation, invested it in production assets, such as power tillers, as well as using it to purchase consumer durables such as radio-cassettes, small rice mills and motorbikes. Although bank savings have not increased in the study village, it is particularly notable that the APB Houn-district service sub-unit has seen a significant jump in cash deposits, especially time deposits. The economic prosperity that was brought about by the introduction of maize relies upon the stability of upland rice cultivation and maize cultivation in permanent upland fields both without fertilizer. The key lies in the successful stabilization of slash-and-burn fields.

Rural finance under a highly commercialized economy (case study 3)

The case study 3 analyzed the financial problems under an unstable market environment (i.e., one with large price fluctuations) in three villages in the Bolaven Plateau that rely on the production of commodities for export such as coffee, beef and cabbage. The surveys found that as villagers expanded their coffee fields following the "coffee boom" of the late 1990s, the APB also engaged in proactive lending; portions of APB loans were extended in-kind (rice for consumption) in order to prevent standing coffee sales. Following a collapse in prices, however, the APB's loans defaulted, causing severe problems in the form of non-performing loans that turned out to be the APB's Achilles' heel. Merchants also dealt in farm loans during the coffee boom, and they too are faced with the difficulties in collecting on their debts. Ever since the APB stopped offering loans, the village's upper strata (i.e., coffee merchants) have been lending money to the lower strata at high

fixed interest rates.

Furthermore, there has been some trade friction between Lao PDR and Thailand on the issue of cabbage exports. The Lao government's response is not being effectively transmitted to the village level, leading to confusion and, eventually, huge losses suffered by farm households.

Finance for rural development in Laos

Based on the results of the three case studies, the paper drafted by the research team for rural finance offers some comments about the current ADB-led initiative to reform the APB. First of all, the APB's performance is acknowledged to be better than expected, in terms of both the savings mobilization (resulting in improving the deposit/loan ratio) and the accumulation of non-performing loans. Second, although the research team recognizes a necessity to separate the fiscal issues from the financial ones, by getting rid of the APB's so-called policy lending they raised questions about the departure away from the special bank for agricultural development towards purely commercial banking. Having perceived the actual conditions in Lao villages, the paper suggests that withdrawing from non-banking services, such as the distribution of seeds and chemical fertilizers, is not always the right direction to take.

Also, the ADB, acting as a micro-financing agency in the APB's stead, is considering developing credit unions that could serve a fairly wide area. The paper points out, however, that ADB does not intend to establish credit unions by integrating village-level saving groups, as described in detail in the paper, and recommends that the existence and significance of these flourishing saving groups at the grassroots level must receive further attention for the establishment of micro-financing institutions.

II-3-c. Surveys on land-allocation program

Since the launch of the land-allocation program, it has had a strong impact on the agricultural and agrarian conditions of the local communities. However, since it is not yet clear to what extent the program has been implemented and to what extent the program has given positive effects on the stabilization of shifting cultivation, the team investigating the land-allocation program conducted case studies in Luang Phabang and Oudomzay provinces in 2003 and 2004 in order to understand what types of land-use patterns have developed and how the allocated lands have been actually utilized following the program's implementation.

Through the case studies in five sample villages, both negative and positive impacts could be observed. What was commonly observed is the introduction of market-oriented crops, between which Job's tear and commercial crops such as vegetables played a remarkable role in providing economic advantages to the local people. However, despite their advantages, it was also observed, particularly in the case of Job's tear, that the program did not succeed in decreasing swidden

agriculture because the slash-and-burn method was still applied to its cultivation. Furthermore, it is also a general observation that the mountainous areas in northern Laos have faced more difficult conditions derived from the lack of accessibility to markets. Although the local people put forth efforts to introduce alternative crops, it is still very difficult for them to completely stop utilizing shifting cultivation and live on commercial crop cultivation alone, because the diversification observed in crop introduction is not equipped with a basis of marketability.

Although problems and limitations generated by the land-allocation program were observed, the distinctive geographical and cultural conditions of northern Laos still have considerable potential and competitiveness in the agricultural sector. In order to make use of this advantage, the government should be pro-active in providing alternative technologies and promoting agricultural products with additional values, such as “*Thammasaat* product of Northern Laos” or “organic product from Northern Laos.” More comprehensive and intensive surveys on the effects of the land-allocation program should be conducted in order to understand the actual conditions of the local communities. Provision of market information and utilization of experienced farmers and merchants are “both sides of the coin” that help develop market-oriented agricultural production. Local government institutions are expected to promote collaboration with such local pioneers, who have accumulated the knowledge and technologies necessary for developing and diversifying agricultural production.

II-3-d. Surveys on agro-ecotourism

In order to understand the current situation of ecotourism and to explore the possible future development of agro-ecotourism, the research team conducted surveys in Luang Phabang province that has a great potential for developing tourism thanks to its richness in nature and cultural heritage. The surveys revealed that the number of tourists coming to Luang Phabang had increased rapidly during 1997-2003 from only 30,769 tourists in 1997 to 99,150 in 2003. As this indicates, tourism is considered to be the main driving force for economic development in Luang Phabang.

The surveys were basically conducted to comprehend the actual situation of the conditions of accommodation for tourists and their interests, including lodging and boarding conditions, tourism destinations, preferences of foreign tourists, and tour programs prepared by local tour-conducting agencies. With regard to agro-ecotourism, the surveys revealed that the word “agro-ecotourism” is quite a new concept for the local tour-conducting agencies. They supposed that the tourists might not be interested in “agro-tourism” in Lao PDR, since the agriculture in Laos is practiced using subsistence manners and has not yet developed. However, to the contrary, interviews with 277 tourists revealed that the majority of them were interested in agro-tourism in different ways. Most tourists to Laos coming on their own, who are medium income people, seek leisure, knowledge and experiences concerning nature, culture and ways of living of the Lao ethnic groups. Moreover, half

of the interviewed tourists expressed interest in learning about the current agriculture techniques practiced by the local people, and sharing a short stay with Lao farmers for three to four days to explore their ways of living.

II-3-e. Surveys related to the One District One Product project

As a supplementary program, the surveys on local products, such as agricultural products, handicrafts and cottage industry products, were organized as a part of activities conducted by the Agriculture and Rural Development Working Group, consisting of two types of surveys: the sample surveys and the inventory surveys. The former was carried out by the NERI researchers and the latter was in collaboration with a Japanese expert and researchers from NERI and the National University of Laos.

The sample surveys were conducted in Phone village, Phone Hong district of Vientiane province, in order to collect relevant information related to the promotion of One District One Product (ODOP) project in Lao PDR. Selecting rattan work as a sample, which is well-known among Vientiane people, the surveys analyzed the production process and marketing systems, and explored the problems and constraints the villagers faced.

The inventory surveys consist of several case studies that were carried out in a plural number of sample districts in northern, central and southern Laos. Based on the information obtained from the interviews with the district-level officers concerned and village elders, all the potential villages in each district were surveyed in order to find out and identify expectable local products. Those results are to be compiled as inventory.

II-4. Economic Integration

II-4-a. Commitment to AFTA

So far, Lao PDR has made progress in liberalizing trade by increasing the number of tariff line to the IL list under CEPT. Now, under the AFTA scheme, all Lao commodities are selected to phase into four lists, namely IL, SL, TEL and GEL.

Tariff Reduction Schedule for Lao PDR under AFTA Scheme

Category	Year of implementation/ Number of items						Items of goods
	1997	2000	2001	2002	2003	2004	
1. Inclusion List (IL)	533	1,247	1,673	2,098	2,535	2,967	Seawater fish, iron, aluminum, turbines, yarn, various types of machinery, etc.
2. Temporary Exclusion List (TEL)	2,820	2,126	1,716	1,291	864	435	Cement, Finished industrial products, processed farm products, etc.
3. Sensitive List (SL)	96	88	88	88	78	75	Livestock, meat, freshwater fish, vegetables, fruit, rice, lumber, etc.
4. General Exception List (GEL)	102	90	74	74	74	74	Stimulants, malt beer, wine, automobiles, etc.
Total number of items	3,551	3,551	3,551	3,551	3,551	3,551	

As illustrated in the table above, Lao PDR started to make 533 items that are effective for the Inclusion List (IL) at the tariff rate between 0-5% in 1997, and the number has dramatically increased year by year. In 2004, the items in IL has increased to 2,967 and Lao PDR has committed to have 98% of its tariff line at the rate level of 0-5% for imported commodities from ASEAN's by 2008. The items in the Temporary Exclusion List (TEL), in which the maximum tariff rate is about 20%, has also dramatically reduced and has moved to IL year by year, and the tariff rate reduction for all items in TEL and the move to IL will be completed by 2008 after an adjustment period. Cement is one of the items in this TEL list. While other items in the Sensitive List (SL) has been slowly reduced, and the Government decided to effectively reduce the tariff rate to 0-5% by 2015, it still has 75 items such as livestock, meat, freshwater fish, vegetables, rice, lumber, etc. in 2004. Along with this, there are 74 items, 15 of which are beer, spirits, wine and other alcohol beverages, and 13 are vehicles in the GEL.

II-4-b. Competitiveness of Lao commodities

A paper written by the Japanese side tries to identify the commodities which Lao PDR has comparative advantages and disadvantages by investigating the available trade statistics. The results of estimating the Revealed Comparative Advantage (RCA) of the relevant commodities reveals that coffee, wood and wood products, apparels and live animals have now achieved strong competitiveness in the international market. In the table below, vegetable plaiting materials (HS code 14) includes 'rattan.' Although bamboo is not shown as an export of Laos in this category within the UN data, bamboo and rattan are included in this category within the data from the Department of Customs of Lao PDR. Also, tin is included under the category of ores (HS code 26). Clearly, Laos reveals its comparative advantage in the agricultural commodities including natural resource goods and handicraft commodities. The findings of this paper are reconfirmed with the study conducted by the Lao working group.

HS code	Product name	RCA
09	Coffee, tea, mate and spices	28.99
44	Wood and articles of wood, wood charcoal	27.11
62	Articles of apparel, accessories, not knit or crochet	16.18
61	Articles of apparel, accessories, knit or crochet	14.61
01	Live animals	12.80
13	Lac, gums, resins, vegetable saps and extracts nes	10.55
14	Vegetable plaiting materials, vegetable products nes	8.68
12	Oil seed, oleagic fruits, grain, seed, fruit, etc, nes	2.65
26	Ores, slag and ash	2.39
36	Explosives, pyrotechnics, matches, pyrophorics, etc	2.06
41	Raw hides and skins (other than furskins) and leather	1.47
43	Furskins and artificial fur, manufactures thereof	1.34
64	Footwear, gaiters and the like, parts thereof	1.30

Of course, the present international competitiveness of Lao products is not enough. However, the overtime changes of competitiveness are very important for policy-making. The results of observations regarding the past changes of competitiveness clearly show that the natural resource commodities such as wood, rattan, live animals and stones have sustained international competitiveness. Unfortunately, the trade structure has not shown any drastic change. Actually, live animals and precious stones have revealed improvements in their competitiveness. However, some natural resource products such as leather products (HS code 42) and furniture (HS code 94) have recently lost their competitiveness. These results are consistent with the findings in the study of the agriculture and rural development working group, and indicating that aromatic rice, yellow cattle and buffalo and maize hold comparative advantages in the international market.

Lao PDR will be involved more deeply in both global and regional economies. At present, Lao PDR enjoys relative competitiveness with its agricultural products. The high growth East Asian

countries have already lost their competitiveness in these products, so it can be expected that Laos will reveal a comparative advantage in such commodities in the near future. It should be emphasized that Laos has a comparative advantage with some foods such as live animals and vegetables. Also, these Lao commodities are recognized as “the *Thamasat*,” namely organic or natural ones, and these food products have the strong potential of future competitiveness. In order to realize such potential, it is indispensable for the government to maintain sound macro policies without overvaluing the exchange rate.

Moreover, the government should pay more attention to the issue of food safety. With regards to it, some cases have recently occurred such as Bovine Spongiform Encephalopathy (BSE), food poisoning and avian influenza. These problems will raise consciousness of food security and affect behaviors of related industries in each country. So, many countries have introduced or prepared legal laws and regulations for food safety.

But regulations sometimes cause some barriers on the import of foods including plants, live animals and so on. For example, Japan has introduced some regulations such as tractability of bovine feeding and breeding to inspect BSE. Owing to the regulation, Japan has not yet agreed to import U.S. beef. Also Thailand, a major importer of Lao exports, has started to take care of food safety problems, and there may be a possibility of introducing some other regulations for other exporters in order to keep its food safety sound. Although many Lao agricultural products, including some animal products, are known well as organic or natural ones, and various certifications or scientific inspections may be required under such regulations.

By seriously taking into consideration such tendencies concerning food safety throughout the world, Lao PDR should prepare some inspection or marketing systems to satisfy the criteria of the imported countries.

II-4.c. Coffee

The paper on the coffee economy in Lao PDR attempts to empirically analyze the coffee sector, which is an important export commodity of Laos. The purposes of the study are: to have a good understanding on the actual conditions of the production and trading systems of Lao coffee, and to explore the potentials of coffee as both an export commodity and a way to obtain political implications. The study discovered that as a result of the various activities of the newly participating private sector in the coffee business, the trade and marketing system as well as production techniques adapted by farmers have been undergoing changes. On the whole, these changes are moving in the direction of improving the quality of Lao coffee.

The coffee sector that had remained stagnant for a long period has come to a turning point in various aspects through the participation of private companies in the coffee business. In addition to the domestic factors such as participation of the private sector in production and marketing,

international coffee prices fluctuate sharply according to the crop situation of major coffee-producing countries. As Lao PDR is a small producer country, the influence is substantial. Under such circumstances, the participation of private companies that have direct access to overseas markets has paved the way for improving the quality of coffee in Laos, such as differentiating the purchasing price of coffee from farmers based on the quality. Lao coffee is produced in a very limited quantity and at the same time faces transportation constraints. It is reasonable that Lao coffee aim for markets that are small but are of high quality and high price. For that reason, in addition to the high quality, it will be essential to define the characteristic features of Lao coffee to gain a brand reputation as good coffee. Coffee farmers in Laos have been producing coffee in the traditional way, that is suitable for its socio-ecological conditions such as climate and soil, labor constraints and also through farming combined with other crops. Therefore, upon promoting the production and export of coffee, it is important that we deepen our understanding of the production, as well as trade and marketing, system that is unique to Laos, as well as deepen the understanding of the needs of potential Lao coffee importers.

II-4-d. Cement Industry

A study carried out by the Lao side tries to investigate the possible scenarios of one typical import-substitution industry—the cement industry—in AFTA. The market's share of domestic products over the country is relatively small, but will increase more than four-folds by early 2007 after completing the ongoing cement plant construction in Khammoun and Saravanh provinces. At present, the Lao cement industry can supply cement commodities to the domestic markets, in particular to those which are close to the Vangvieng Cement Plants I & II. However, in many provinces, they still need to import cement from neighboring countries.

Demand for cement, particularly for public infrastructure as well as business and household consumption, are growing rapidly. This offers market opportunities for the Lao cement industry. However, under the AFTA/CEPT scheme, the Lao cement industry will face cheaper imported cement without tariff after 2008. In terms of price competition, when the import tariff for imported cement is reduced to 0%, Lao cement commodities can compete with Thai cement in Vientiane, but not in the southern part of Lao PDR. The price of cement produced by the new cement plant in Savannakhet is more expensive than that produced by the Vangvieng Cement Plant. In terms of quality, the cement products made by the Cement Plant No. II are acceptable in comparison with international standards. However, the cement products made by the Cement Plant No. I are below international standards. In terms of comparative advantage, the Lao cement industry has potential concerning material resources and labor cost, while it has disadvantages due to its high transportation cost, high cost of technology, spare parts supply, lack of equipment, inflation, unstable exchange rate and debt burden, etc.

The Lao cement producers should take the following measures to sustain and survive in regional integration. Those are to improve the capacity of cement production and improve the quality of cement products, and to minimize production costs by cutting unnecessary costs and aim to reduce sell prices up to a competitive level. Along with this, its management, organization and productivity of cement production should be improved, and the workers and staff are required to be upgraded and trained in accordance with the needs for modern production, management and marketing. Also, it needs to study the comparative advantages of their competitors in neighboring countries, and to establish a research and development division on cement production and marketing,

Accordingly, recommendations for the Lao cement industry are as follows: 1) to reconsider a price determination mechanism to improve the efficiency of the Lao cement industry, and 2) to promote the establishment of a quality control system, in particular to adapt to international quality standards.

II-4-e. Prospects of Motorcycle sector

Now, motorcycle demand in Laos is high and is expected to become higher. In this market, many motorcycle companies from various nations are competing intensely. Decades ago, it was not difficult for the Lao government to develop this sector by taking protective measures against imports. However, because Lao PDR has to be fully compliant with AFTA conditions in less than three years, and is in the process of its accession to the WTO as well as preparing to be integrated into a few other economic blocks, it is almost impossible to develop sectors with no comparative advantage by way of governmental protection.

As a result of the study, the paper presents the following as to what the Lao government can do to promote the motorcycle sector:

1) To encourage local motorcycle assemblers to shift further to the IKD system.

Shifting to IKD is in some ways a result of government policies combined with rational decisions of private companies. And for Lao PDR, it is natural that the more it shifts towards IKD the better, because Laos will gain the created value-added products with this shift. Private companies will continue the shift to IKD as long as it is reasonable; on the other hand, the government is required to make the preference clear. Although it is still difficult to decide where development of this sector is viable, it depends on the government attitude whether private companies are encouraged to move towards this direction.

2) To encourage assemblers to improve the quality of locally produced parts through training by foreign experts:

Private companies have to decide where and how they can earn maximum profits. Some motorcycle assemblers produce some of the necessary parts locally, because it is affordable. On the other hand,

competition among countries in manufacturing finished goods would be more and more difficult as economic integration advances. In a country, like Laos, where a large amount of foreign aid is available, one consideration is to channel this aid towards capacity building for producing higher quality parts in order to position Laos within the production linkage of ASEAN.

- 3) To enhance efforts to attract part-makers, which hold a comparative advantage in production in Laos.

The Lao government should appeal directly to thousands of part-makers operating in neighboring countries about the merits of moving to and operating in Laos.

- 4) Finally, the Lao government should continue its efforts to find solutions for piracy problems faced by the motorcycle sector.

The Lao government should continue to cope with piracy problems in this sector and create a fairer competitive environment within the domestic market. A fair competitive environment will not only increase the confidence of foreigners, but may also contribute by attracting more foreign direct investments into the country.

II-4-f. Introduction of Foreign Direct Investments

Another paper from the Japanese side recommends that as a land-locked country, Lao PDR can introduce an industrialization strategy, which is complementary to the ASEAN sub-region.

As many as 5,000 Japanese-affiliated companies are based in Thailand today. On account of this concentration, industries in Thailand such as the automotive and home appliance production, which require large supplies of precision parts and sophisticated technology, have come to boast a global level quality and cost competitiveness.

However, due to the rise of labor and production costs, Japanese-affiliated firms in Thailand are now struggling with cost cutting measures. Although cameras, cellular phones, VCRs and other high-tech products are composed of a large number of lightweight high-tech parts, this does not necessarily mean that the production of those parts is capital-intensive. When the labor-intensive parts of production are slowly losing its comparative advantage in Thailand, they can be shifted to the neighboring countries including Lao PDR. This also reinforces parts production in cross-border regions and revives the cost competitiveness of the parts industry in Thailand.

For example, labor-intensive parts that constitute high-tech products, such as the vibrator of cellular phones, microchips for home appliances, trigger coils used in digital camera flashes, wire harnesses and other automotive parts would be manufactured in Laos and then sent to the Thai plant, where they are assembled with other components. The Thai plant would supply these parts to such companies as SONY, TOSHIBA and NOKIA located in Thailand or to such companies as TOYOTA

and HONDA if they are automotive parts, or export them to its own plant in a different country. Since the marketing route is already established in this way, the Lao plant is able to receive sufficient lot orders and enjoy the scale merit. Thus, Lao PDR does not need to develop a new export market for the parts manufactured by the Japanese-affiliated companies within Laos. Accordingly, the geographical condition of being 'landlocked' is not a disadvantage for Laos.

III. Concluding Remarks

III-1. Human resource development

The fact that the proportion of children accounts for a large part of the population indicates future high population growth in Laos. Therefore, primary education and healthcare measures are definitely important for poverty-reduction as well as for economic and social development.

In addition, to enhance the governance of the government and modern sectors in Laos, human resource development is a must. Particularly in the governmental organizations, it is an urgent requirement to upgrade the capacity of macro-economic and development policy formulation. Moreover, issues on socio-economic data collecting and processing should be taken care of in a serious manner.

Furthermore, for the purpose of pursuing industrialization, it is necessary for Laos to systematically improve and expand a technical education system in universities, high schools and vocational schools.

III-2. Government's Active Roles towards Stability and Development

As discussed above, the government should perform diverse and active roles in maintaining stable macro-economic conditions and developing each production sector efficiently. The most fundamental issues of macro-economic management are to reduce the budget deficit and to keep the local currency and financial conditions sound. Only when these prerequisites are maintained, will the Lao people trust and advocate for the market economy and economic policy of the government. The government should manage its macro-economic policy in a "market-friendly" manner.

Furthermore, for the purpose of economic development in the wave of global economic integration, the government is required to design a long-term plan which includes public investment. At the same time, it is also necessary to play an active role for making development policies to various sectors from agriculture to manufacturing, especially towards the development of the industries with potential comparative advantages. This "market enhancing role" is another important role of the government. Anyhow, the government should commit to make all policies credible toward

the Lao people and the other countries.

Appendix

**Policy Recommendations on “Challenges for Integration “in Lao PDR
By MAPS2 Japanese Working Group Members**

As a consequence of the two-year cooperation in MAPS2, the Lao and the Japanese sides have successfully presented a fruit of both sides' joint efforts as the final report. However, in consideration of imminent difficulties to be tackled by Lao PDR, Japanese working group members decided to propose the following recommendations at the completion of this joint works. Based on our recommendations, Lao counterparts are expected to make due considerations and take immediate actions.

0. Basic concepts

Lao PDR should challenge the risks and take advantage of opportunities in the promotion of the economic integration, mainly through fully utilizing the potentials unique to Lao PDR. For the attainment of that way, it is a fundamental condition to maintain the market-friendly macroeconomic policies, especially the fiscal and financial policies.

1 Fiscal and financial sector policies

(1)The fiscal deficits financed directly or indirectly by the banking system resulted in high inflation and large non-performing loans in the banking sector, which brought about a loss of confidence in its currency and in the banking system.

(2)To solve the banking sector problems, it is essential to restructure fiscal conditions and to introduce discipline in fiscal management. New laws and regulations should be introduced to ensure the banking sector's independence and autonomy.

(3)The Lao government should improve fiscal management. Further efforts should be

introduced to improve tax collection and to widen its tax base. Government expenditures, particularly capital expenditures, should be scrutinized more carefully. In this context closer coordination among bilateral and multilateral donors and the Lao government ministries is also necessary.

2 Small and Medium sized Enterprises Policies

(1) Dispatching an industrial mission to industrialized countries is to provide an opportunity to compare the current situation of Lao industry with that of abroad, which is to stimulate the Lao entrepreneurial spirits and to support the Lao entrepreneurs' self-efforts for "discovering the market."

(2) An industrial exposition held in Lao is to raise an awareness of overall quality enhancement and production methods improvement, plus to promote disseminating and sharing technical information embodied in the manufactured products exhibited.

3. Agricultural and Rural development policies

(1) Location-specific approach should be adopted by taking into account the regional diversity of Lao PDR when the agricultural policies are implemented.

(2) The Lao government should pay attention to what is actually taking place in countryside and try to involve the pioneering agencies such as experienced farmers and local merchants into the policy implementation under the development of market-oriented economy.

(3) The promotion of potential products with additional values, such as thammafaat products of Laos or organic products of Laos, is expected to provide an alternative way.

4 . ODOP

- (1) For promoting development in the *thammasaat* way, identification of the products should be undertaken by organized, particularly village /district level, efforts.
- (2) Regarding the exportable local products, the Lao government should collaborate with non-governmental agencies in order to promote their production and marketing. In addition, the government should take into serious consideration the increasing concerns about global food safety, and start to architect a necessary institution to provide the qualified Lao products. And with regard to it, the Lao government is expected to identify regional prospective products and develop them so as to differentiate them with the neighboring countries' products.

5 . Policies toward Economic Integration

- (1) Lao economic policies including fulfillment of agreed AFTA schemes should obtain the credibility among the Lao people and the other countries.
- (2) The Lao government should recognize the strength and weakness of Lao industries in the Asia and global markets. And, it should sustain the market-friendly policies without suffocating the international competitiveness of the growing industries by keeping the exchange rate at un-overvalued level. On the other hand, the prudent and cautious policies are required to the international competitive industries
- (3) The Lao government should establish the transparent policies to invite foreign direct investments in the complementary industries, which will accelerate the production linkage in ASEAN.

6. Human Resource Development

(1) To enhance the governance of the government and modern sectors in Lao, human resource development is must. Particularly in the governmental organizations, it is an urgent requirement to up-grade capacity of macro-economic and development policy formulation. Then the issues on socio-economic data collecting and processing should be taken care of seriously.

(2) For the purpose of pursuing industrialization, it is necessary for Lao to systematically improve and expand technical education system in universities, high schools and vocational schools.

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