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Economic Integration WG

1. Summary of Economic Integration WG

Yonosuke HARA

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.

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.

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.

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, particularily 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.

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.

Introduction of Foreign Direct Investments

Another paper from the Japanese side recommends that as a land-rocked 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.

2. Trade Structures and Export Competitiveness in Lao PDR and the East Asian Countries

Yonosuke HARA
Hisato SHUTO

1 Introduction

In order to be able to discuss about issues relating to future economic integration concerning Lao PDR, it is significant to understand about trade structures. As demonstrated by trade theory and other countries' development experiences, export competitiveness not only reflects a country's endowment in various aspects such as natural resources, physical capital and human resources, but also governance and the policy performance of the country. In this paper, we evaluate the export competitiveness structure of Lao PDR and examine the dynamics of trade structure through the experiences of other East Asian countries. Furthermore, various issues for improving the export competitiveness of Lao PDR will be discussed based on the findings on trade structures.

2 Measurement of Export Competitiveness

In this article, we analyze some measurement indices describing the trade structure of Lao PDR and other countries. For the analysis of trade structure, we sometimes consider the share of export and import commodities as basic information. However, we focus here on some of the indices for analyzing export competitiveness[1].

2.1 Trade specification index/net export index

It is generally understood that a commodity has export competitiveness if there is little need to import it. To highlight this characteristic, the competitiveness index or trade specification index (TSI)/net export index is defined as follows:

$$TSI_j^i = \frac{X_j^i - M_j^i}{X_j^i + M_j^i} \tag{1}$$

where TSI_j^i denotes the trade specification index/net export index of commodity i for country j. X_j^i and M_j^i denote the export and import values of commodity i of country j. The range of this index is from -1 to +1. Supposing that a commodity is exported but not imported at all, the trade specification index of this commodity would be +1. On the other hand, commodities with a trade specification index of -1 are only imported and not exported at all. That is, a positive value of this index corresponds to high

[1] Balassa (1989), Yeats (1990) and Vollrath (1991) are introduced for understanding various indices for export competitiveness analysis.

export competitiveness.

There are advantages to using this index for analyzing export competitiveness. It is usually the case that the same commodity is imported as well as exported. If a country imports more than it exports a commodity, describing that commodity's competitiveness based on only its export value may be insufficient. Since the trade specification index includes both the export and import values, it can shed light on such a situation. In particular, for the flying geese hypothesis as will be discussed later, it is desirable to use this index.

A further advantage is the aggregation aspect of this index. First, the TSI for total commodity can be described as follows:

$$TSI_j = \frac{X_j - M_j}{X_j + M_j} \tag{2}$$

where X_j and M_j denote a country j's total export and import value, respectively. This index of total net export can be disaggregated as follows:

$$TSI_j = \frac{X_j - M_j}{X_j + M_j} = \sum_i \left(\frac{X_j^i + M_j^i}{X_j + M_j} \right) \left(\frac{X_j^i - M_j^i}{X_j^i + M_j^i} \right) = \sum_i w_j^i \times TSI_j^i \tag{3}$$

That is, the trade specification index for total net export values can be described as the weighted average of trade specification indices of commodities on this country's trade. This relationship can then be adopted for the aggregation/decomposition of this index by destination of trade:

$$TSI_j = \frac{X_j - M_j}{X_j + M_j} = \sum_k \sum_i \left(\frac{X_{j-k}^i + M_{j-k}^i}{X_j + M_j} \right) \left(\frac{X_{j-k}^i - M_{j-k}^i}{X_{j-k}^i + M_{j-k}^i} \right) = \sum_k \sum_i w_{j-k}^i \times TSI_{j-k}^i \tag{4}$$

where k denotes the trade partner k for country j.

2.2 Balassa's Revealed Comparative Advantage (RCA)

The Revealed Comparative Advantage (RCA) is an index of export competitiveness. It is possible to calculate the share of one commodity in total exports of a given country. This value can be compared with the share of this commodity in total world exports. If the export share of this commodity for the country is larger than the export share of this commodity in world trade overall, the country can be said to have export competitiveness in the commodity, because the commodity occupies a greater share in exports of this country than the world average. From this example, the definition of RCA can be described as follows:

$$RCA_j^i = \frac{X_j^i / X_j}{X_w^i / X_w} \tag{5}$$

where RCA_j^i denotes the RCA index of commodity i of country j. X_j^i denotes commodity i's export value by country j and X_j denotes the total export value j. X_w^i and X_w represent the export values of commodity *i* in the world and of all commodities in the world. If an exporting country has a comparative advantage in a commodity, the ratio for this index would be over +1.

From the above definition, RCA can be defined as the ratio of the share of a country's exports in one commodity market to that in the world commodity market, that is,

$$RCA_j^i = \frac{X_j^i / X_w^i}{X_j / X_w} \tag{6}$$

In this definition, if an exporter *j*'s presence in commodity market *i* is larger than that its total exports in world exports (average), the country has comparative advantage in this commodity market if RCA is over +1.

As a measurement of export competitiveness, RCA has some advantages. First, RCA reveals relative presence in the world export market. This is desirable as an index of competitiveness in world market. The second point is that it is easy to estimate because it can be derived from export data alone. At the same time, however, this index has a aspect which we should heed. This index depends on the degree of disaggregating commodities. In contrast to the trade specification index, RCA can not be disaggregated by commodity or trade partner. For this reason, there is uncertainty as to which aggregation level of the commodity classification should be analyzed. For example, there are two standard commodity classifications in trade data: one is the Standard International Trade Classification (SITC) and the other is the Harmonized System (HS) of classification. SITC has 5 disaggregation levels of commodities from 1 digit to 5 digits. Similarly, HS has 6 disaggregation levels of commodities from 1 digit to 6 digits. In analyzing RCA on SITC data, the 3-digit level has often been used.

3 Trade Structure of Lao PDR

3.1 Data

There are various sources for trade data on Laos. The first is the detailed data from the Department of Customs, Ministry of Finance. This has been recently prepared based on the Harmonized System (HS) and is available using the computerized system[2].

Another source is the United Nations Commodity Trade Statistics Database (UN COMTRADE). In this data set, Laos' data is not available as a reporter country but is available as a partner country. Therefore, in our analysis of Laos' trade structure based on UN COMTRADE data, other countries' imports from Laos are taken as Laos' exports. In addition, other countries' exports to Lao PDR are understood as Laos' import data. However, there are some problems with this method. Foremost, the inconsistencies between the export data and import data are well known. In addition, not only Lao PDR but also Cambodia, Myanmar, and Vietnam are not reporter countries to UN COMTRADE. That is, none of the data on the trade flows among CLMV countries is available. This is a crucial problem for analyzing the trade structure of Lao PDR.

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[2] Since we accessed this data immediately prior to submitting this article, we regret that we could not conduct a thorough analysis based on this data.

However, it is useful to analyze the trade structure of Lao PDR based on UN COMTRADE data if we can understand the problems and limitations for using it.

3.2 Competitiveness

3.2.1 RCA of Lao PDR

Based on the PC-TAS UN/ITC (UN COMTRADE), RCA at the 2-digit HS level is derived as in Table 1. The RCA values are calculated as an average of the data for 1999-2001 and 2003. We omitted data for 2002 from our calculation because Thailand's data was not reported in 2002. In Table 1 we show the commodities that possess a comparative advantage as defined by the RCA equation as having a value larger than one. As mentioned above, this table is derived by using data of actual imports from Laos to estimate Laos' exports, so there may be some differences from the calculation based on Laos' original trade data. However, the recent figures for Laos' export competitiveness can be understood from this table.

Table 1: RCA of Laos' commodities at 2-digit HS level

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

Source: Calculation based on PC-TAS UN/ITC

Note: The RCA figures are derived as an average for data from 1999-2001 and 2003 because of the unavailability of Thailand's data for 2002.

It is shown that coffee, wood and wood-related products, apparel goods, live animals have a high RCA value. Vegetable plaiting materials (HS code 14) includes rattan. Although bamboo does not appear as exports out of Lao PDR (imports from Lao PDR) in this category in the UN data, bamboo and rattan are included in this category in the data from the Department of Customs of Lao PDR. In addition, ores (HS code 26) include tin. This analysis reveals that Lao PDR has a comparative advantage in the natural resource-related goods and handicraft goods.

3.2.2 Trade specification index

Mention of trade structures sometimes leads to interest in the trade partners. For this, it is useful to analyze the trade specification index/net export index (TSI), because TSI can be decomposed by partner country and by commodity sub-category. In Table 2, we derived TSI values from total exports and total imports, and their decomposition by partner and by 2-digit HS level commodity category. Here we show only 2-digit HS level commodities with positive TSI values and list them in order of TSI value. Moreover, these figures are derived as 4-year averages from data for 1999-2001 and 2003. The TSI for total exports and imports is -0.397 signifying that Lao PDR is a net importing country in the commodities trade. This figure can be decomposed by partner and by commodity, as shown in equation (4). For example, Laos' weighted TSI in wood-related articles (HS code 44) to Thailand is 0.073. We can then calculate the weighted TSI for this commodity to all destinations (0.096) as the sum of all TSI values in this row.

We can derive the weighted TSI for all commodities to each destination as a sum of the values for each country or region's column. The sum of the final column and final row corresponds to the TSI of total exports and imports.

After this explanation of the structure of these tables, we discuss the findings. First, we compare export competitiveness structures between TSI analysis and RCA analysis. As can be seen from the final column in both Table 1 and Table 2, the list of commodities with export competitiveness is similar. From Table 2, we can identify wood, coffee, apparels, and vegetable plaiting materials as goods with a comparative advantage.

Second, with regard to the countries that make up the trade partners of Lao PDR, we can see that (1) the competitiveness structure for each commodity in the world market is similar to that for the Thai market. This can be verified by comparing the final column with that for Thailand. (2) Laos' comparative advantage in apparel goods is reflected in the numbers for Europe. The positive value of 0.12 for the sum of the column for Europe indicates that apparel imports by Europe contribute to the net total exports from Lao PDR.

3.2.3 Changes in trade structure of Laos' commodities

We are interested in not only the present trade structure but also its changes. As we mention later, many other East Asian countries have experienced drastic changes in their trade structures, and the dynamics of comparative advantages are understood as the engine of their higher growth rate. From this point of view, we are interested in studying the past experiences of change in Laos' trade structure in order to discuss future possibilities and problems.

Figure 1 shows the change in RCA of selected commodities at the 2-digit HS level. Since export data is derived from data of other countries' imports from Lao PDR and since the figures for cases of smuggling cannot be captured quantitatively, these RCA values may not reflect sufficiently the actual competitiveness of Laos' exports. Nevertheless we can recognize roughly the transition in the trade structure. We take up the commodities for which data is available almost for the entire evaluated period. In this figure, we can identify natural resources or goods as the competitive commodities of Lao PDR. In general, the trade structure has not changed drastically. However, looking at live animals and precious stones, their competitiveness has improved. However, the fact that the overall structure relies on the natural resource-related commodities has not changed. Also, we are aware of some commodities that have lost their competitiveness. These include processed products made from natural resources, such as leather products (HS code 42) and furniture (HS code 94). This illustrates that Lao PDR is competitive in natural resources, wood, rattan, live animals and stones, but that there is some possibility that the competitiveness of processed products may experience a slight decrease. However, we need to do further research on Laos' original trade data, because there are some problems with using trade data from other countries.

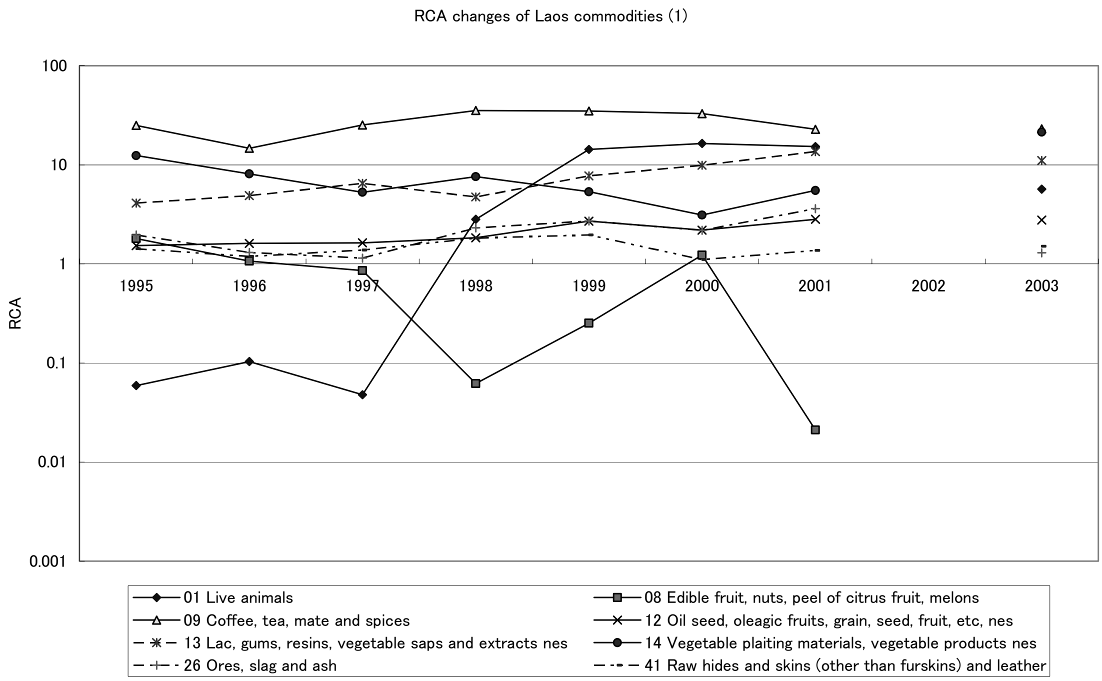
Table 2 : Decomposition of trade specification index by partner and commodity

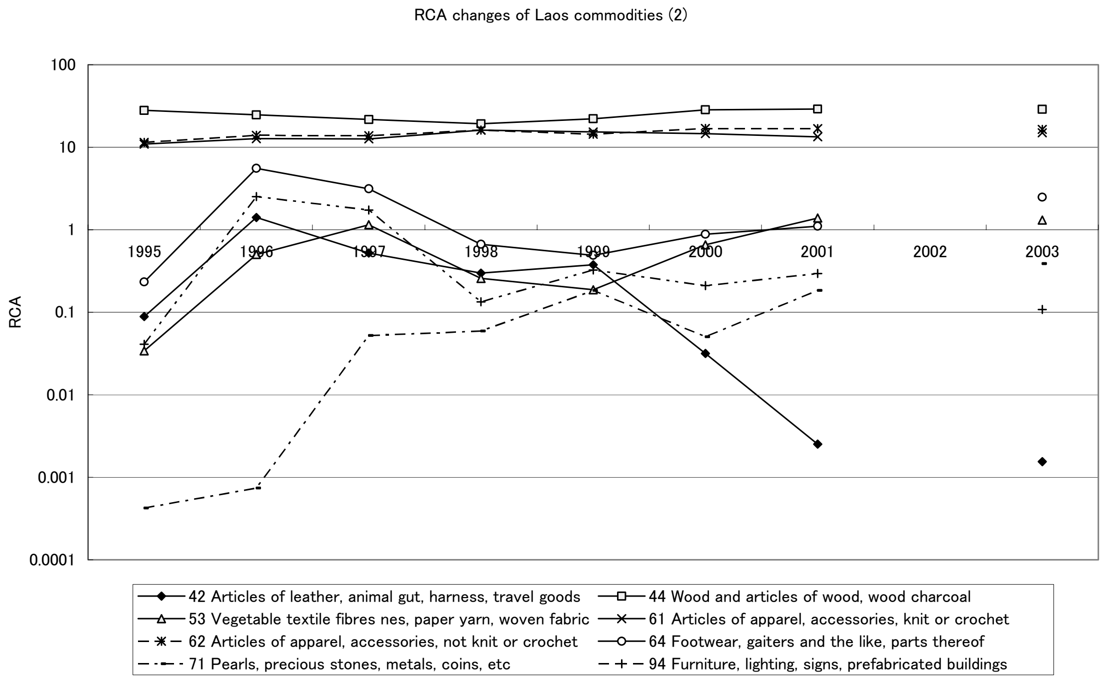
HS code	Products name	China	Hong Kong	Japan	Korea	Taiwan	Indonesia	Malaysia	Singapore	Thailand	South Asia	Other Asia	Europe	America	Oceania	Africa	Total
44	Wood and articles of wood, wood charcoal	0.00730	0.00002	0.01038	0.00020	0.00337		0.00003	0.00000	0.07296		0.00006	0.00109	0.00004	0.00014		0.09560
62	Articles of apparel, accessories, not knit or crochet	−0.00051		0.00033	−0.00029	0.00000	−0.00012		0.00015	−0.00073	−0.00013	0.00021	0.08026	0.00486	0.00003		0.08405
61	Articles of apparel, accessories, knit or crochet	−0.00036	0.00010	0.00049	−0.00092	0.00011			0.00066	−0.00129		0.00009	0.05583	0.00717	0.00016		0.06203
09	Coffee, tea, mate and spices	−0.00008					0.00039		0.00205	0.00010		0.00021	0.01617	0.00006		0.00060	0.01951
01	Live animals	0.00006								0.00418			−0.00001				0.00423
26	Ores, slag and ash									0.00355							0.00355
12	Oil seed, oleagic fruits, grain, seed, fruit, etc, nes	0.00101			0.00052	0.00006				0.00086			0.00020				0.00265
64	Footwear, gaiters and the like, parts thereof	−0.00038		0.00020				−0.00002		−0.00170			0.00310				0.00120
13	Lac, gums, resins, vegetable saps and extracts nes	0.00003								0.00071	0.00004		0.00026			0.00003	0.00106
41	Raw hides and skins (other than furskins) and leather				−0.00004					0.00073			0.00001	0.00031		−0.00007	0.00095
14	Vegetable plaiting materials, vegetable products nes									0.00021							0.00021
43	Furskins and artificial fur, manufactures thereof									−0.00004			0.00019				0.00015
07	Edible vegetables and certain roots and tubers	−0.00015								0.00021							0.00006
47	Pulp of wood, fibrous cellulosic material, waste etc									0.00004							0.00004
	Others	−0.05803	−0.00109	−0.02002	−0.00711	−0.00197	−0.00008	−0.00207	−0.03201	−0.47155	−0.00291	−0.00316	−0.03756	−0.00329	−0.00588	−0.02544	−0.67216
	Total	−0.05111	−0.00097	−0.00862	−0.00765	0.00157	0.00019	−0.00206	−0.02915	−0.39175	−0.00300	−0.00258	0.11954	0.00916	−0.00555	−0.02488	−0.39687

Source: Calculation from PC-TAS UN/ITC

Note: This figure is derived as an average from data for 1999-2001 and 2003 because of the unavailability of Thailand's data for 2002.

Figure 1: RCA changes of selected Laos' commodities for 1995-2003





Source: Calculation from PC-TAS UN/ITC

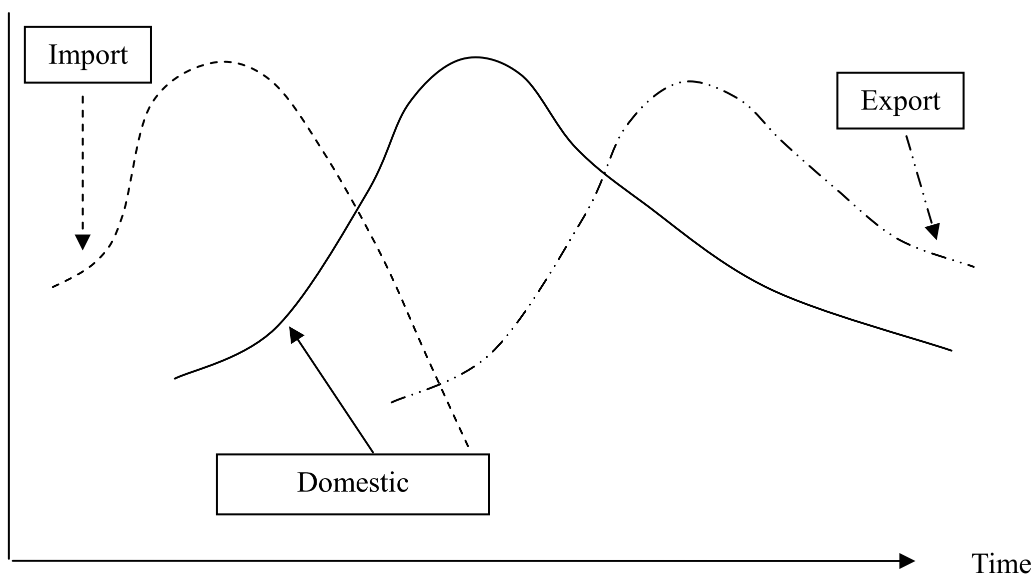
Note: The figure for 2002 is not derived because of unavailability of Thailand's data.

4 Historical Experiences of East Asian Countries

4.1 Dynamics of trade structures – the "flying geese" hypothesis

In trade theory, the comparative advantage principle is known as the basic theorem. Here, suppose that commodity X can be produced by technology for which labor input is used more intensively than capital, and commodity Y can be produced by using capital more intensively than in labor. Under such a technology structure and in the situation in which the economy of country A has more abundant labor than country B, one principle of comparative advantage tells us that both countries can improve their welfare if A exports X and B exports Y. Of course, this principle only applies if very strict assumptions are satisfied, but its essence is useful for understanding the past path of economic growth in East Asian countries where the importance of factor endowment is recognized. This endowment includes not only natural resources but also human and physical capital. That is, we can understand how accumulating skills and technology is an important issue for development when we recognize the relationship between principles of comparative advantage and economic growth. In particular, if focus is placed on the dynamic processes of trade and production structure, the importance of trade for economic growth should be confirmed. In the experience of economic development in Asia, the "flying geese" hypothesis of development is well-known. This "flying geese" hypothesis is described as the time path of trade and domestic production (see Figure 2).

Figure 2: "Flying geese" hypothesis



4.2 Experiences of other countries

In this section we use the AID-XT[3], trade data prepared by the Institute of Developing Economies based on UN COMTRADE and others, in order to describe the dynamics of trade structures of East Asian countries. We describe the transition of trade structures in this region, and the figures for competitiveness are attached in the appendix. Here we discuss the main findings of the transition of the competitiveness structures for each country.

Japan:

Japan has not shown a drastic change in its competitiveness structure since the 1980s for the period in question. Machinery commodities show strong competitiveness during the period under study. Particularly road vehicles have shown strongest competitiveness and kept it level since the end of 1970s. However, it should be noted that there is a change in the competitiveness structure among the machinery commodities. General machinery, telecom and sound equipment, and office machines lost their competitiveness in the 1990s, and electrical machinery parts have maintained relative competitiveness. This finding is consistent with the dynamics of competitiveness in other East Asian countries, which have increased their competitiveness in office machines and telecom equipment. While those countries have become exporters of such items, they rely on the supply of the parts for those commodities from Japan.

China:

There has been a drastic change in China's trade structure since the introduction of the market system. This can be seen from the fact that competitiveness of heavy industries such as petroleum products has decreased since the end of the 1980s. On the other hand, some manufacturing items, such as footwear, miscellaneous manufactured goods have exhibited their competitiveness since this period. In addition, since the end of the 1990s, office machinery and telecom equipment have increased their competitiveness. Although some food items, vegetable, fruit, and fishery products have slightly lost their competitiveness, China has remained a net exporter in those food items.

Korea:

South Korea has lost its competitiveness in items related to apparel and footwear. On the other hand, machinery commodities have become important components of its export structure. Road vehicles, transport equipment, telecom and sound equipment, and office machinery have gradually become more competitive. Electrical machinery parts that revealed high competitiveness in the early 1990s lost their position suddenly as of the late 1990s.

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[3] The Ajiken Indicators of Developing Economies Extended for Trade Statistics, the data system adjusted, maintained and administered by the Institute of Developing Economies, is composed of trade statistics from the United Nations (UN COMTRADE database), the Organisation for Economic Co-operation and Development (OECD; International Trade by Commodity Statistics: ITCS), and Taiwan (Monthly Statistics of Imports/Exports, The Republic of China, Taiwan District)

Singapore:

Singapore has shown high competitiveness in office machinery since the mid-1980s. Although no drastic change in their overall trade structure can be observed during the period under study, the competitive position of office machinery, and telecom and sound equipment has declined, while electrical machinery parts increased their competitiveness suddenly in the late 1990s.

Thailand:

In Thailand, office machinery, and telecom and sound equipment have become more competitive recently. At the same time, traditional export items have decreased their position in the competitiveness structure. For example, cereals, vegetable, fruits, and crude rubber lost their competitiveness in the early 1990s, and the competitiveness of apparel clothing items decreased also in the mid-1990s. On the other hand, fishery commodities have increased their position in Thailand’s export structure. On the whole, Thailand’s primary products have retained their competitiveness.

Malaysia:

Malaysia’s competitiveness in office goods and telecom equipment has recently increased. On the other hand, traditionally competitive items such as crude rubber, cork and wood, and apparel clothing accessories have lost their competitiveness. Also, competitiveness of fixed vegetable fats and oil has decreased but these items have still kept their comparative advantage. Electrical machinery parts, which had a positive trade specification index value, have lost their competitiveness since the late 1980s. Furniture and furniture parts have improved their competitiveness gradually, and cork and wood products have kept their competitiveness.

Philippines:

In the Philippines there has been a less drastic change in its competitiveness structure than the other East Asian countries. However, office machines have increased their competitiveness, as in other countries. Likewise, electrical machinery parts have recently shown an increase in their competitiveness. On the other hand, vegetable fats and oils, and vegetables and fruit have gradually lost their competitiveness.

Indonesia:

Indonesia was highly competitive in exports of natural resources such as petroleum and gas. Although there has been a large decrease in the competitiveness of those items recently, they still remain competitive. Similarly, coffee has maintained its competitiveness despite a gradual decrease. As for cork and wood manufacture, footwear, and the processed items from natural resources, textiles or rubber, they have all continued to hold a positive trade specification index value.

In summarizing the experiences of other countries in East Asia, it is apparent that they have shown drastic changes in their trade structures and competitiveness. As is well-known, these changes have been brought about by an export-oriented strategy accompanied with foreign investment and introduction of appropriate technologies for each country. This strategy has been supported by stability in the macroeconomy and in policy implementation[4].

5 Important issues for Laos' competitiveness

In the future, Lao PDR will increase its participation in both the global and regional markets than presently. There is a possibility that under such regionalization frameworks as the ASEAN Free Trade Area (AFTA) neighboring countries will decrease their tariffs/customs duties. In such a case, foreign exchange as well as domestic savings will in the future become more important than before as sources for investment. At present, Lao PDR enjoys competitiveness in natural resource-related products. As mentioned above, since the competitiveness of high-growth East Asian countries in such products has significantly decreased, it is expected that Lao PDR will establish a comparative advantage in such commodities in the near future. Additionally, Lao PDR has a comparative advantage in some foods items, such as live animals and vegetables. In particular, the demand for meat in East Asian countries will increase. In addition, Lao food is recognized as being organic and natural. From this perspective, such food products have the potential for becoming competitive in the future. Nevertheless, in order to realize such a potential, Lao PDR should engage its efforts in various issues as discussed below.

5.1 Food safety issues

In the past few years, many food-related safety problems have emerged in the world such as bovine spongiform encephalopathy (BSE), food poisoning, avian influenza, and others. Such problems affect the safety of our food as well as the performance of related industry in each country. Therefore, many countries have introduced or prepared legislation and regulations to ensure food safety. Such regulations sometimes impose barriers to the import of certain food items including plants, live animals and so on.

For example, Japan has introduced regulations for beef such as traceability of feed and breed, testing for BSE before the meat is marketed, among others. Japan does not agree with the U.S. with respect to the method of inspection for BSE before the meat is marketed as U.S. beef to Japan. As of present, the beginning of 2005, the import restriction on U.S. beef in Japan still has not been lifted. From this example we can see that every country is concerned about the food safety problem, and this sometimes presents legal barriers to trade. Thailand, which is a major trading partner of Laos, is concerned about food safety problems. This may lead to the possible introduction of certain regulations for exporters of food to Thailand so that food safety in Thailand can be maintained. Although many Lao foods are well-known as being organic and natural, various certifications or scientific inspections could be required under such regulations.

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[4] See also World Bank[1993].

With the present situation surrounding food safety problems in the world, Lao PDR will also be required to implement inspection or marketing systems to satisfy the criteria of importing countries. In order to do this, Lao PDR should look toward and collect information about food safety issues and policies of other countries.

5.2 Regionalization and globalization

There are various issues surrounding regionalization and globalization. Recently, a number of trade agreements among East Asian countries have been introduced. How should we understand the effects of such regionalization/globalization on Laos' economy, especially on its trade structure?

Lao PDR as well as other less developed countries enjoy various preferential trade agreements with other countries. For example, the general system of preferences (GSP) gives preferential treatment to Lao PDR for exports[5].

For example, Lao PDR benefits from being able to export garments under the GSP to Europe. On the other hand, further regionalization and globalization could mean lower trade barriers among many countries in a region and the world. This compels Lao PDR to be interested in the future effects of preferential trade agreements for the less developed economies with further regionalization and globalization.

For example, an agreement on tariff preferences between Thailand and China went into effect in 2003, ahead of the schedule of tariff preferences under the ASEAN-China agreement. This agreement may affect Laos' economy in that vitalization of trade between China and Thailand would bring about positive impacts on Laos' economy. On the other hand, competition between China and Lao PDR in Thai markets could become more severe than ever; similarly Thailand in China's markets.

Under such circumstances, it is necessary to establish an environment for developing entrepreneurship, making efficient investment, and maintaining a long-term outlook. A stable and credible policy for vitalizing production, marketing, services, and the business sector should be set up. Such an environment would lead to improvement in efficiency in the future so as to be on the same level with players in other countries[6].

6 Summary

In this article, we discuss the trade and export competitiveness structures of Lao PDR with the limited data available. We find that Laos' natural resource and related goods have a comparative advantage. However, we also find this structure has not changed during the past ten years or so. This means that we should focus on the sustainability of this present trade structure as well as the country's endowment in

[5] The World Bank Vientiane Office [2004] is a useful resource for understanding the preferential agreement for Lao PDR.

[6] We interviewed a private company in Thailand. He told us that they are concerned about political risk as the most important point when they invest in any other foreign country. That is, ad hoc policy changes often interfere with their investment decision.

natural resources. Furthermore, the future progress of regionalization and globalization will impose a more severe competitive situation on Lao PDR even though some preferential trade agreements for less developed economies will be maintained. There are many things that Lao PDR should take in from the experiences of other East Asian countries. One of the important things is to prepare an environment in which players in Laos' economy can sufficiently perform to their potential. In order to establish such an environment, functional but stable economic policies are needed. In other words, ad hoc or inconsistent policies would negatively impact not only the players in Lao PDR but also foreign partners/investors.

In addition, some economic policies of foreign countries should be of interest to Lao PDR, and such information should be collected. It is apparent, for instance, that food safety problems and related regulations in other countries would be significant to the future Laos' export competitiveness. In order to support farmers, producers, traders, manufacturers and other related players, the government and private sector should cooperate with each other and make efforts on such issues.

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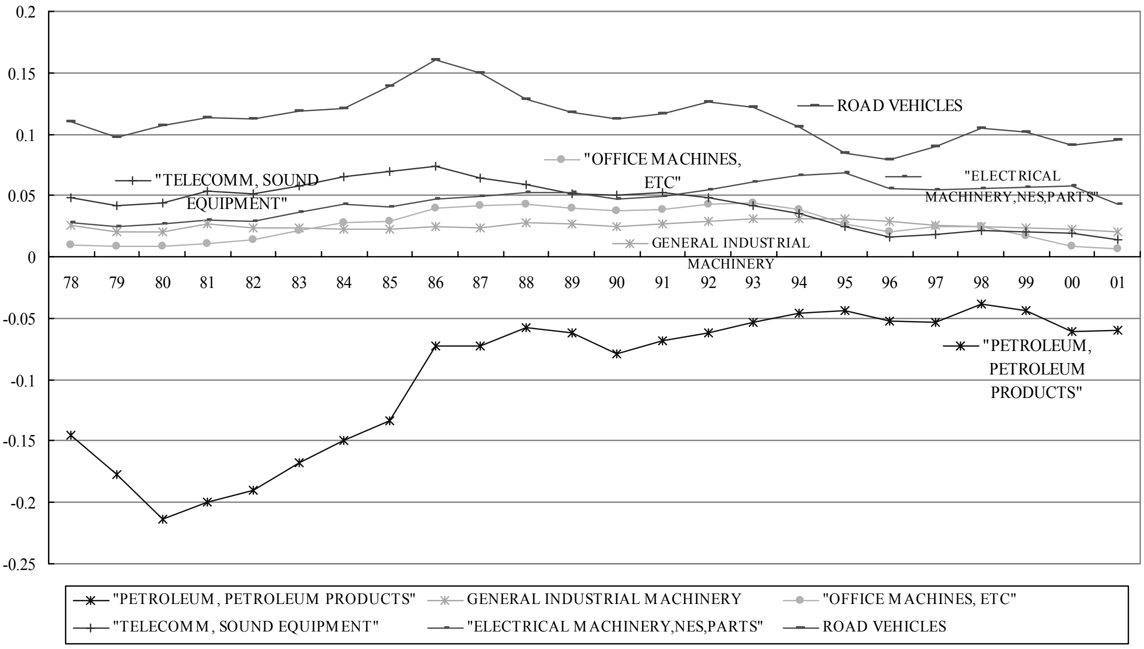
Appended Figures:

Selected Commodities' Weighted Trade Specification Index of East Asian countries at 2-digit SITC level

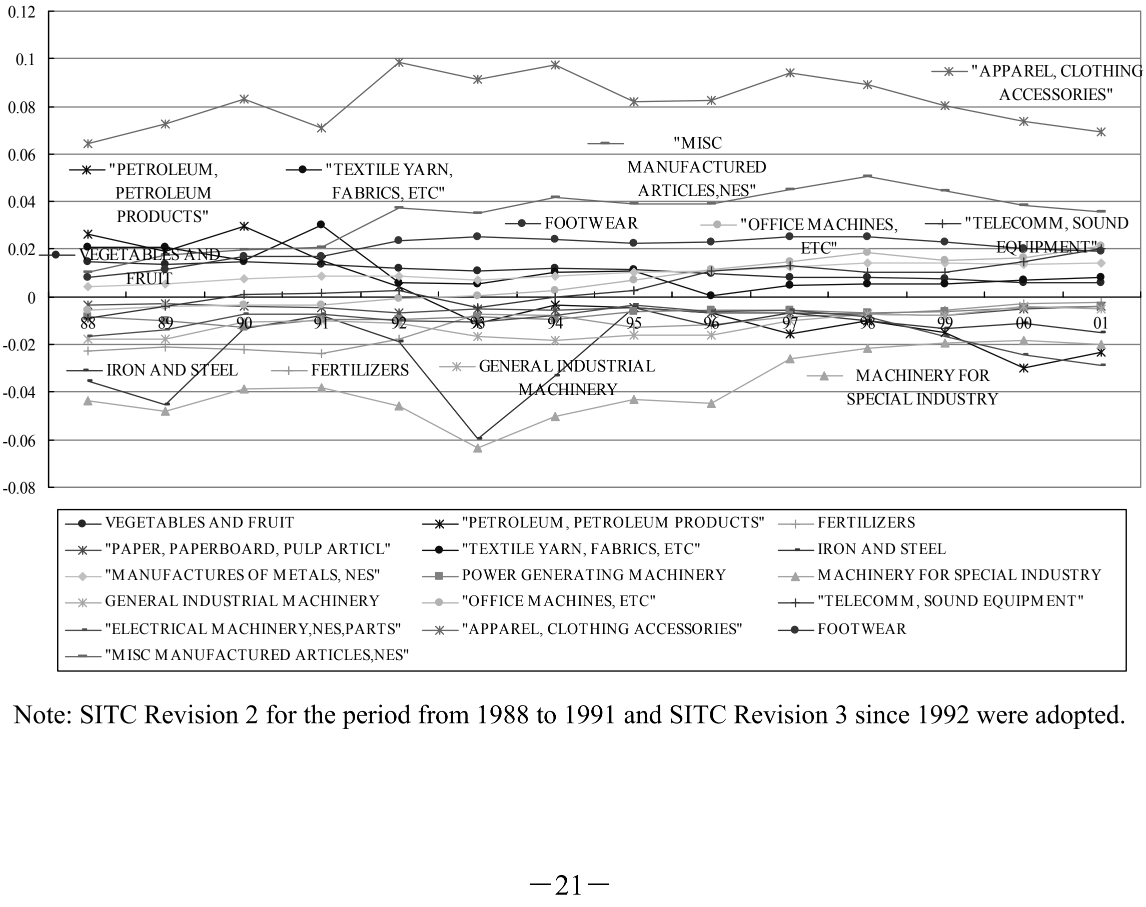
(These figures are estimated from IDE, AID-XT.)

JAPAN



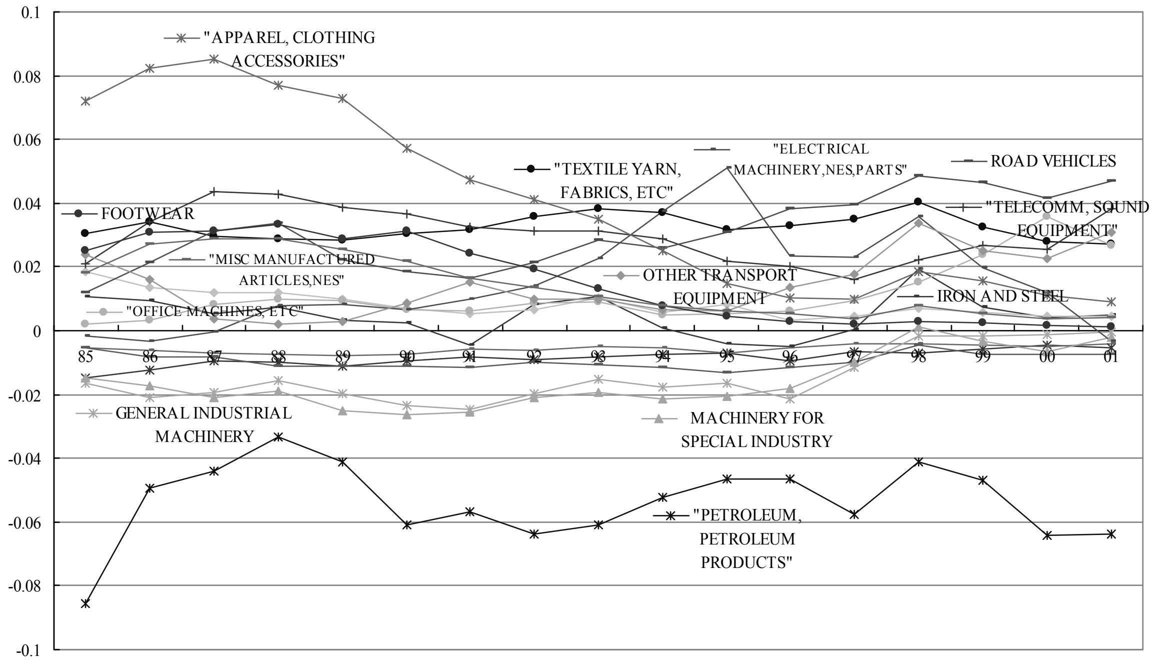
Note: SITC Revision 2 for the period from 1978 to 1987 and SITC Revision 3 since 1988 were adopted.

CHINA



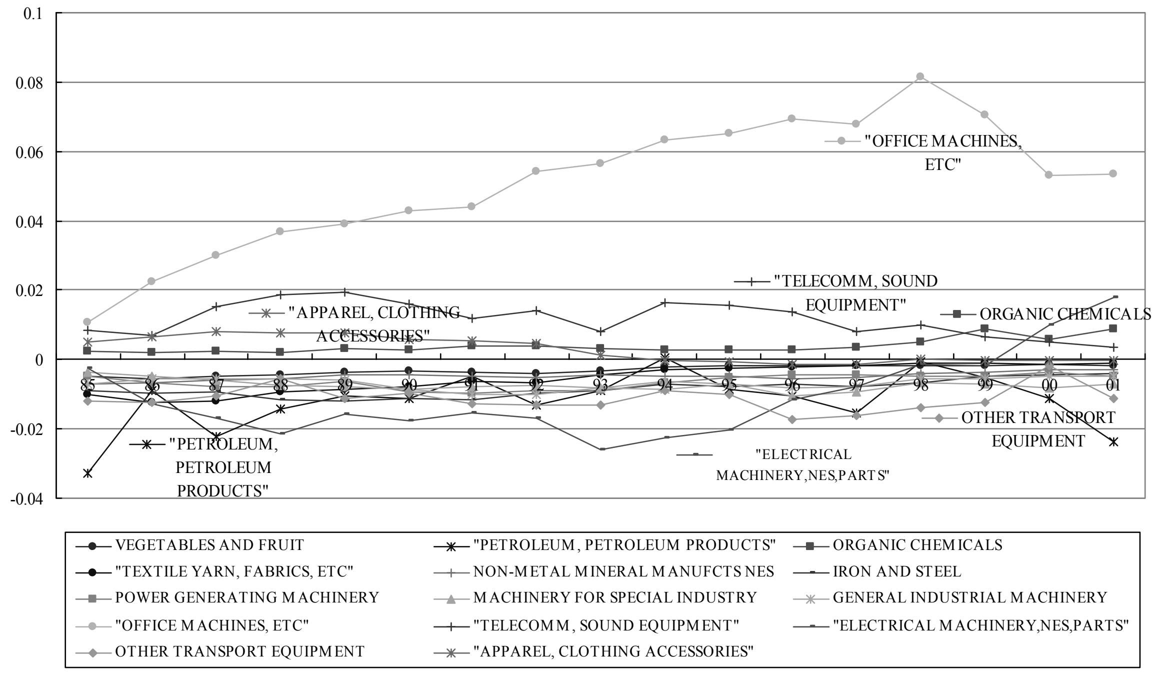
Note: SITC Revision 2 for the period from 1988 to 1991 and SITC Revision 3 since 1992 were adopted.

KOREA



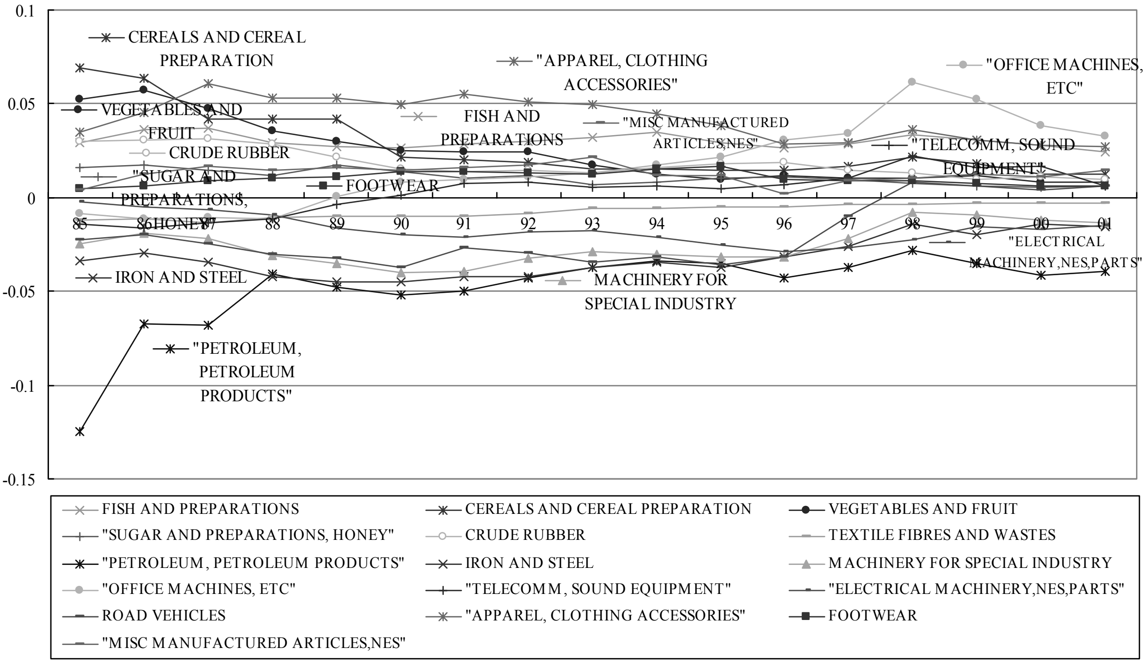
Note: SITC Revision 2 for the period from 1985 to 1987 and SITC Revision 3 since 1988 were adopted.

SINGAPORE



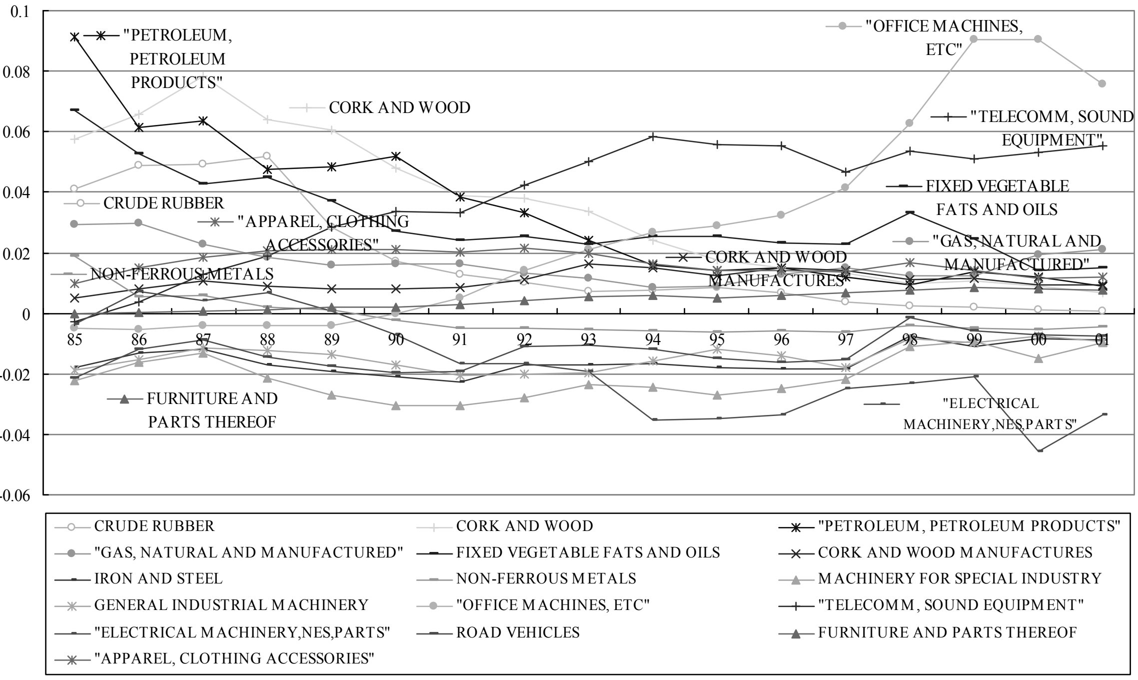
Note: SITC Revision 2 for the period from 1985 to 1988 and SITC Revision 3 since 1989 were adopted.

THAILAND



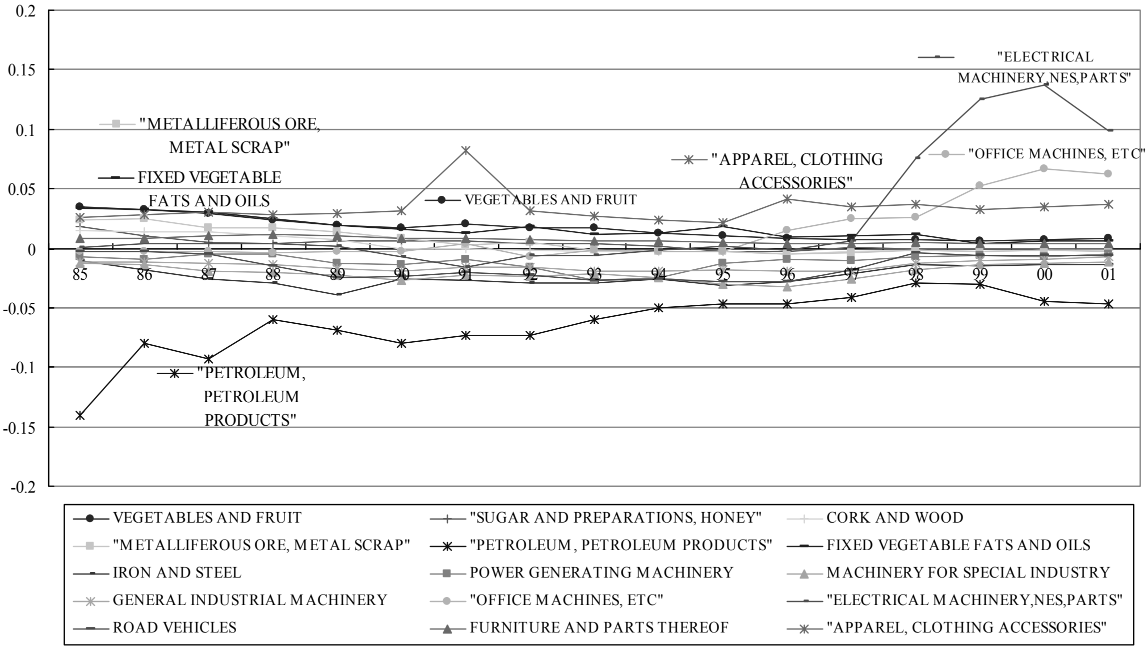
Note: SITC Revision 2 for the period from 1985 to 1987 and SITC Revision 3 since 1988 were adopted.

MALAYSIA



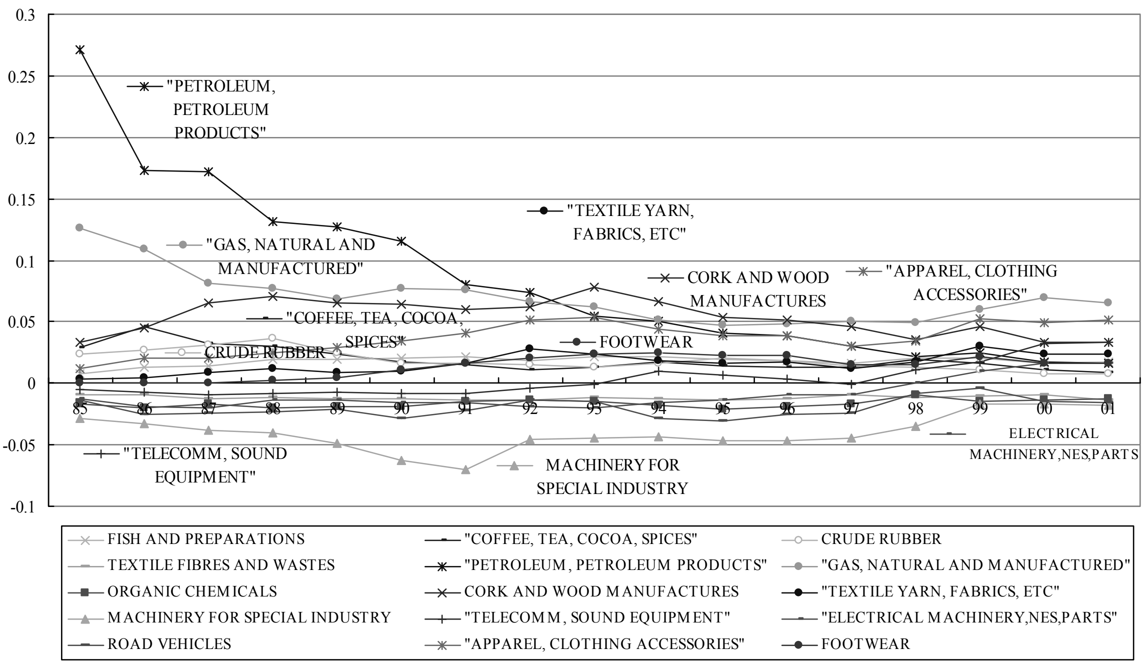
Note: SITC Revision 2 for the period from 1985 to 1987 and SITC Revision 3 since 1988 were adopted.

PHILIPPINES



Note: SITC Revision 2 for the period from 1985 to 1990 and SITC Revision 3 since 1991 were adopted.

INDONESIA



Note: SITC Revision 2 for the period from 1985 to 1988 and SITC Revision 3 since 1989 were adopted.

3. Subregionally Complementary Industrialization Strategy for Laos under Economic Unity

Motoyoshi SUZUKI
Souknilanh KEOLA

Summary

In the "Japan-ASEAN Plan of Action" (2003), Prime Minister Koizumi announced that Japan will place emphasis on (a) cooperation for reinforcing the integration of ASEAN through the Mekong region development and other initiatives, and (b) cooperation for enhancing the economic competitiveness of ASEAN member countries including investment promotion. Prime Minister Koizumi also agreed to enhance support and cooperation for promoting economic and social development in the Mekong region in the "Tokyo Declaration for the Dynamic and Enduring Japan-ASEAN Partnership in the New Millennium" (2003). However, it is necessary for donor countries, surrounding countries, as well as Laos itself, to recognize anew that the Lao government is in a position to benefit from the development of the framework for subregional cooperative relationship especially in the Greater Mekong Subregion (GMS) and the Japanese government's aid program for Indochina.

The primary objective of this paper is to describe how the various changes inside and outside of the Mekong subregion, such as the end of the Cold War, the establishment of peace in Cambodia, the shifting of the socialist countries to a market economy, the expansion of ASEAN, and economic unity, had a positive effect on the development of the Mekong subregion.

Second, this paper discusses the difficulty for a landlocked country with no coastline such as Laos to fully reap the benefits of a traditional import substituting industrialization strategy which focuses on imposing high tariffs in an era of economic unity even if it attempted to implement the strategy. The third objective is to propose a "complementary industrialization strategy for landlocked developing countries" to take the place of the import substituting industrialization strategy. The major points of the strategy are outlined below.

(1) Subregionally complementary industrialization strategy for landlocked developing countries

As many as 5,000 Japanese-affiliated companies are based in Thailand today. Thanks to this concentration of plants, industries in Thailand requiring large supplies of precision parts and sophisticated technology, such as the automotive and home appliance industries, have come to boast global scale quality and cost competitiveness.

However, due to the rise in the costs of labor or production, Japanese-affiliated firms in Thailand are now struggling with the issue of cost reduction. Cameras, cellular phones, VTRs and other

high-tech products are composed of a large number of lightweight high-tech parts, but this does not necessarily mean that the production of those parts is capital-intensive. Rather, labor-intensive production is frequently a more rational option. In other words, if the labor-intensive parts production sector that is slowly losing its comparative advantage in Thailand can be shifted to neighboring Laos, it could complement and reinforce parts production in cross-border regions and revive the cost competitiveness of Thailand's parts industry.

(2) Economy of scale and the export market

Invariably, it is the Thai plant, where strategy headquarters is located, that determines which parts are to be manufactured in which country or region within the AFTA framework. Therefore, the strategy is not a zero-sum game where a Thai plant is to be closed in its entirety and moved to Laos. Rather, it calls for the production of only the labor-intensive parts from among all parts that are presently produced to be shifted to Laos, and for the manufactured parts to be sent back to the Thai plant. For example, labor-intensive parts that constitute high-tech products—the vibrator of cellular phones, microchips for home appliances, trigger coils used in digital camera flashes, wire harnesses and other automotive parts, etc.—would be manufactured in Laos and then sent to the Thai plant, where they will be incorporated with other components. The Thai plant would supply these parts (i) to such companies as SONY, TOSHIBA and NOKIA located in Thailand, or (ii) to such companies as TOYOTA and HONDA if they are automotive parts, or (iii) 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 orders for a sufficient lot, and in addition to enjoying merit of scale, it does not need to develop a new export market for the parts manufactured by the Japanese-affiliated companies in Laos. Clearly, the landlocked geographical condition of Laos is not a disadvantage in terms of location.

(3) Advantageous location for the labor-intensive parts industry

The minimum wage in Thailand is 150 baht/day in Bangkok, whereas it is a mere 50 baht/day in Laos, even when taking fringe benefits into consideration. The difference in wage level is plainly obvious, and clearly indicates that Laos is an appropriate site for the labor-intensive parts industry.

(4) Thai trainers play a core role in the transfer of technology

Japanese-affiliated companies in Thailand have already succeeded in training Thai instructors. Therefore, inviting such Japanese-affiliated companies from Thailand could expedite the transfer of technologies to Lao plants.

(5) On-site training at Thai plants

Lao employees can receive training at their respective company's plant in Thailand. Since Laos and Thailand are physically close to each other and have similar cultural and linguistic backgrounds, in terms of technology acquisition there is a distinct locational advantage to training Lao workers in Thailand.

(6) First and Second Mekong International Bridges

When completed, the second Mekong International Bridge will connect Thailand and Laos by road just as the first bridge will provide land access between Vientiane and Nong Kai, and it is expected to considerably reduce physical distribution time in the southern areas as well.

(7) Reduction of time and cost spent on logistics (transportation, physical distribution, customs, overhead costs, etc.)

The highway network projects (construction of the East-West Corridor, North-South Corridor, and South Corridor) constitute the core of the Greater Mekong Subregion (GMS) Economic Cooperation framework. It would not be an exaggeration to say that their success depends not so much on the development of necessary infrastructure, but rests largely on the reduction of time and cost for logistics, which include transportation, physical distribution, customs, and overhead costs. The streamlining and expediting of export and import procedures to and from Laos forms the backbone of the subregionally complementary industrialization strategy proposed in this paper, and is undoubtedly an issue of paramount importance that must be addressed by the Lao government. JICA can provide technical assistance in the areas of customs and trade operations to help facilitate trade in the subregion by dispatching short and long-term experts to Laos.

(8) Export promotion system

Because the application of the Common Effective Preferential Tariff (CEPT) will deprive the Lao government of its tariff revenue, it needs to compensate for the loss with two domestic taxes, namely the turnover tax and excise tax, for the time being. At the same time, however, the Lao government must urgently examine preferential export measures, including a tax system in which no domestic tax is applied to goods that are produced in Laos and exported to Thailand, and create an export promotion system independent of the domestic tax system. By implementing such an export promotion measure, the government would be able to attain the two major objectives of securing tax revenues and increasing exports simultaneously. JICA can also provide technical assistance for the construction of the export promotion system through the dispatch of short and long-term experts.

(9) Designating the Savan=Seno Special Economic Zone (SEZ) as an “Export Processing Zone”

The writer feels that inviting the labor-intensive parts industry of Japanese-affiliated companies in Thailand to the Savan=Seno Special Economic Zone (SEZ) is the most reasonable means of assuring the success of the SEZ in the landlocked country of Laos. When inviting companies to the Savan=Seno SEZ, however, at least a part of the SEZ should be designated an export processing zone to allow a strong complementary relationship to develop between Lao plants and Thai headquarters on the cost front. In this zone, products manufactured using raw materials and parts imported from Thailand and other foreign countries are to be exempted from excise tax, turnover tax, and value-added tax (VAT), as described in section 8 above, under the condition that they will all be exported.

For manufacturing trade plants operating outside the SEZ, such as in Vientiane, a refund system of such domestic taxes as excise tax, turnover tax, and VAT should be established and implemented. JICA can provide technical assistance for the development of the export processing zone, its operational methods, and the creation of a tax refund system by dispatching and training short and long-term experts as well as by holding forums.

(10) Establishment of a “Special FDI Mission” under the Prime Minister

In order to pursue the subregionally complementary industrialization strategy described above, it is vital for the relevant institutions to upgrade their functions. Undoubtedly, it is of absolute importance that specialized knowledge and experience is accumulated by the Department of Domestic and Foreign Investment (DDFI) from the perspective of inviting foreign direct investment, by the Ministry of Legal Affairs in terms of developing a legal system, by the Ministry of Commerce in relation to import and export procedures and other areas for facilitating trade, and by the Ministry of Industrial Handicrafts and the Committee for Planning and Cooperation (CPC) in areas pertaining to the establishment and operation of the Savan=Seno Special Economic Zone (SEZ) and the export processing zone. At the same time, a Special FDI Mission should be created under the direct supervision of the Prime Minister to coordinate these institutions with the objective of providing one-stop service. This effort would also demonstrate Laos’ strong commitment to improving the foreign investment environment both internally and to the outside world. JICA can contribute by providing guidance in areas urgently needed in Laos today and in the development of the investment environment through the dispatch of short and long-term experts. The more than 5,000 Japanese companies in Thailand are lacking accurate information on Laos’ investment environment. If Japanese experts could make direct visits to Japanese-affiliated companies in Bangkok or hold investment and business forums in Laos with the cooperation of the Japan External Trade Organization (JETRO), new opportunities will surely open up for foreign direct investment in Laos.

3. Subregionally Complementary Industrialization Strategy for Laos under Economic Unity

1. The History of the Mekong Committee Symbolizing the Complicated History of Indochina

There is no doubt that the creation of friendly relations between Laos, a landlocked country with no coastline, and the neighboring countries surrounding the Mekong River Basin will serve to bring peace and prosperity to Laos. However, the history of Mekong River Basin development, as represented by the Greater Mekong Subregion Development Cooperation scheme of the Asian Development Bank, was in no ways a smooth path.

In 1946, the year following the end of World War II, the First Indochina War broke out with the French bombardment of Hai Phong. In 1954, the French were defeated at Dien Bien Phu, and the Geneva Accords were signed, in effect dividing Vietnam into northern and southern zones. After the withdrawal of the French troops from Vietnam, America increased its involvement in Indochina. In 1957, the Mekong Committee was established in response to the decision taken by the United Nations Economic Commission for Asia and the Far East (ECAFE), an organization in which the US and other Western countries wield considerable influence. The economic development of the Mekong Basin countries was indispensable to controlling the infiltration of communism from Indochina. Ultimately, the Mekong Committee failed to obtain the membership of China, Burma (now Myanmar), and North Vietnam, and was composed of only Thailand, Laos, Cambodia, and South Vietnam. This limited membership was certainly a reminder of the fact that the Mekong Committee is a product of the US-Soviet Cold War era. The Japanese government also dispatched a team of investigators and experts to the Mekong Committee, and contributed to numerous on-site studies related to the development of power resources, afforestation, and flood control in the Mekong River Basin (Hori 1996, 101-201). On the one hand, the activities of the Mekong Committee greatly helped accumulate important data through various studies. On the other hand, however, it is said that only a handful of projects were completed, including the Nam Ngum Dam project in Laos, and that although many other projects were planned and their on-site surveys carried out, they were abandoned before actual construction even began.

In 1962, Burma became a socialist country. In 1975, the Vietnam War ended. In December of that year, the Lao People’s Democratic Republic came into being, and socialism spread rapidly throughout Indochina. The Mekong Committee had been forced into inactivity around this time, but in 1978 it was re-established as the Mekong Interim Committee by Thailand, Laos, and Vietnam. However, because the outbreak of the Cambodian Conflict wrought havoc on the political situation in Indochina, the interim committee was unable to pursue substantive activities. In this way, the history of the Mekong Committee as described above overlaps with the history of the “tragedy of Indochina,” and is heavily tinged with the conflicts and turmoil of the US-Soviet Cold War era.

1. The End to Chaos and Signs of Peace

The region surrounding the Mekong River began to show signs of conflict resolution and peace in the latter half of the 1980s (Shiraishi 2004, 204). The economic reform policy known as *Perestroika*, which was introduced by the Soviet Union at the 27th plenary session of the Communist Party held in 1986, quickly spread to the countries of Indochina and formed the basis of the "Chinanakan Mai (new thinking)" policy in Laos and the "Doi Moi (innovation)" policy in Vietnam. These countries demonstrated a serious commitment to addressing economic reforms and an open-door policy both internally and externally.

As symbolized by the fall of the Berlin Wall, 1989 saw enormous changes in the Soviet Union and the countries of Eastern Europe. This state of affairs placed Vietnam and Laos in a position where they had no choice but to review their relationships with the Soviet Union. With the collapse of the Soviet Union in 1991, Soviet aid to Laos and Vietnam, which formed the core of aid to the two countries, was cut off completely (Suzuki 1994), making it necessary for Laos and Vietnam to approach Western capitalist countries and international organizations in search of new donors. At this time, the Western donor community was also ready to fully resume its cooperation to the Indochina countries owing to several favorable developments: Vietnam's withdrawal of its forces from Laos and Cambodia in 1989, the signing of the Paris Peace Agreements on Cambodia in 1991 (Shiraishi 2004, 205), the return of King Sihanouk to Cambodia in November 1991 after a 13-year period of exile, and finally the establishment of the United Nations Transitional Authority in Cambodia (UNTAC) in March 1992. Furthermore, internal conditions in China also ripened for it to actively address the development of the Mekong River Basin, due to the fact the China's rapid reform and open-door policy brought serious economic disparities between the coastal and inland areas of the country, and it became necessary to consider fully opening up the Yunnan Province and other frontier regions as a measure to redress regional disparities (Shiraishi 2004, 204). The normalization of Sino-Vietnamese relations in 1992 for the first time in 13 years is also worthy of mention as one of the essential conditions for attaining peace in Indochina and for promoting cooperation in the development of the Mekong River Basin.

2. The Expansion of ASEAN

Another significant event that contributed to mitigating the conflictual state of affairs in the latter half of the 1980s was the change in Thailand's diplomatic policy. Up to then, Thailand had been reacting strongly to Vietnam's military intervention in Cambodia. However, Prime Minister Chatichai, who assumed premiership in 1988, worked to bring peace to Cambodia by announcing realistic policies that would "turn the battlefields of Indochina into a lucrative market," and taking vigorous measures to solve the Cambodian problem and to make peace with the Phnom Penh administration and Vietnam. Behind Thailand's decision to take the initiative in addressing the Cambodian peace process was the increasing military and economic presence of China in the Asian region, the establishment of NAFTA, and the expansion and strengthening of the EU, which alarmed and threatened the original ASEAN countries.

Thailand took these developments as a significant opportunity to expand the ASEAN market by aligning the socialist countries of Indochina that were then shifting toward market economies. The socialist countries of Indochina had been caught up in an economic bottleneck as socialism began to collapse. However, as the first giant step toward an open-door policy, economic unity, and participation in the global community, Vietnam became an official member of ASEAN in 1995, Laos and Myanmar in 1997, and Cambodia in 1999, resulting in the establishment of the ASEAN10. Article 14 of the Constitution of Laos formulated in 1991 supports the open-door policy as a priority issue. It stipulates that: "The state protects and expands all forms of state, collective and individual ownership, as well as private ownership of domestic capitalists and foreigners who make investments in the Lao People's Democratic Republic. The state encourages all economic sectors to compete and cooperate with one another in expanding their production and business." As also indicated by Articles 12 and 18, the Constitution clearly advocates the two policies of active participation in the global community and economic unity. Article 12 states that "The Lao People's Democratic Republic pursues the foreign policy of peace, independence, friendship and cooperation; and promotes the relations and cooperation with all countries based on the principles of peaceful coexistence; respect for - each other's independence, sovereignty and territorial integrity; non-interference in each other's internal affairs; equality and mutual benefit," and Article 18, that "The state promotes and advises on the development of economic relations with foreign countries in many forms on the basis of the principle of respect for each other's independence, sovereignty, equality, and mutual benefits" (Suzuki 2002, 144-145).

3. From Mekong Congestion to a Greater Mekong Subregion (GMS)

The end of the Cold War and the establishment of peace in Cambodia also brought about major changes in the global community's provision of aid. Conventionally, aid was provided on a one-country basis, but in place of this approach, a framework of multilateral regional cooperation began to take shape. Around this time, the globalization of production and financial activities and advances in transportation and communications technologies revolutionized business practices and further deepened the structure of international interdependence (Morizono 2002, 30). In order to develop a country that can adapt to this new order, it became necessary to provide not only bilateral aid, but also regional cooperation spanning multiple countries, or multilateral aid. Indeed, a number of frameworks symbolizing "the era of regional cooperation" was formulated in Indochina in the 1990s. An overview of these frameworks is provided below.

(1) Mekong River Committee (MRC)

The Mekong Committee was established in 1957, but was re-established in 1995 as the Mekong River Committee (MRC), with its headquarters transferred from Bangkok to Phnom Penh, the capital of Cambodia. The signing of a partnership agreement with the Asian Development Bank in March 2003 is expected to enhance the effectiveness of MRC activities.

(2) Asian Highway Network

In 1959, the United Nations Economic and Social Commission for Asia and the Far East (ECAFE) initiated the Asian Highway Project, a scheme to construct a large network of roads connecting fifteen countries in Asia through 40 routes totaling 65,000 kilometers. Its progress was interrupted by the repercussions of the Indochina conflict, but in 1995, the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP; the former ECAFE) approved a new and upgraded plan for the construction of 42 routes stretching a total of 90,000 kilometers.

(3) Forum for Comprehensive Development of Indochina (FCDI)

During Japanese Prime Minister Miyazawa's visit to Bangkok in January 1993, the Forum for Comprehensive Development of Indochina (FCDI) was proposed to be held to formulate well-balanced development strategies for the entire Indochina region. As a result, the first ministerial meeting of FCDI was held February 1995 in Tokyo chaired by Japan (Morizono 2002, 17). The Joint Statement (1995) adopted at the meeting acknowledged that, in order for the three Indochina countries to utilize limited resources to the maximum advantage and benefit, it is critically important to give appropriate consideration to the "subregional aspects" of development when formulating development programs and projects.

(4) ASEAN Mekong Basin Development Cooperation (AMBDC)

The Fifth ASEAN Summit held in Bangkok in December 1995 initiated the ASEAN Mekong Basin Development Cooperation (AMBDC), which was proposed by Prime Minister Goh Chok Tong of Singapore and strongly supported by Malaysia. The objective of AMBDC is to contribute to political and economic stability in the Mekong Basin, and upholds the principle of selecting projects through policy dialogues among member countries. One of its major projects is the proposed development of a trans-Indochina railway extending from Singapore to Kunming, but the problem of fund procurement has not yet been cleared.

(5) AEM-METI Economic Industrial Cooperation Committee (AMEICC)

The AEM-METI Economic Industrial Cooperation Committee (AMEICC) was originally founded in 1994 as the Indochina Myanmar Industrial Cooperation Working Group, and was reorganized as the Cambodia Laos Myanmar Industrial Cooperation Working Group (CLM-WG) in 1995. To further strengthen its functions, the CLM-WG was restructured at the ASEAN Economic Ministers-Minister of Economy, Trade and Industry of Japan (AEM-METI Japan) consultations held in 1997, and became the AMEICC (Morizono 2002, 29). AMEICC focuses on strengthening the competitiveness of ASEAN countries, promoting industrial cooperation, and providing economic cooperation to new member countries. There are eight working groups under AMEICC: (1) human resource development, (2) small and medium enterprises and supporting industries, (3) local industries, (4) East-West Corridor development, (5) statistics, (6) automotive industry, (7) chemical industry, and (9) textile industry

(Nomoto 2002, 96).

(6) Greater Mekong Subregion (GMS) Economic Cooperation

In 1992, the year following the establishment of peace in Cambodia, the Asian Development Bank proposed the Greater Mekong Subregion Economic Cooperation (GMS) program that would bring together the six countries of the Mekong subregion into an attractive investment and production market. The subregion comprises Vietnam, Laos, Cambodia, Thailand, Myanmar, and China's Yunnan Province. With about 2.3 million square kilometers of land, a combined population of 250 million, and a nominal GDP of about 190 billion dollars, the subregion is a potentially large market (Asian Development Bank 2001). In order to develop the Mekong subregion as a single market zone, GMS development projects must first focus on building roads and other infrastructure. In regard to the construction of a road network, much effort is being devoted particularly to the construction of the East-West, North-South, and South Corridors. When completed, the East-West Corridor will link Da Nang Port in Vietnam with Mawlamyine in Myanmar by a 1,500-kilometer road running through Savannakhet in Laos and Mukdahan in Thailand. The North-South Corridor will connect Bangkok with Chiang Rai, where it will divide into the Lao route and Myanmar route, merge again at Kunming, and stretch to Hai Phong Port via Hanoi. The South Corridor will extend from Bangkok to Phnom Penh, the capital of Cambodia, through Siem Reap, the Cambodian city known for the Angkor Wat monuments, to Ho Chi Minh, and further to Vung Tau Port, where it meets the Pacific Ocean. These three corridors combined will stretch over 4,000 kilometers, and their completion in 2007 is fervently anticipated (Suzuki 2004, 11).

There are so many subregional cooperation schemes that they are ridiculed as causing "Mekong Congestion," but among them, the Greater Mekong Subregion (GMS) Economic Cooperation of the Asian Development Bank is favorably evaluated as the one framework displaying high effectiveness. Morizono (2002, 51) gives the following reasons for its distinction.

(1) ADB's GMS budget for fiscal 2001 (11 million dollars for technical cooperation, 286 million dollars in loans) was about 15 times the annual budget of the Mekong River Committee (20 million dollars), a clear indication that ADB has an overwhelming advantage as a development and financial institution in terms of international mobility of capital and technology.

(2) Since project formulation is fundamentally based on the initiative of each country, ADB has little trouble obtaining consensus.

(3) Regular ministerial-level meetings of the central planning, financial funding, and budget control authorities of each country help clarify budgetary procedures, and thereby ensure that the effectiveness of projects are maintained.

In terms of planning, implementation, budget, and coordination among countries, it would be most realistic and efficient to integrate and implement the projects and programs being carried out by the above-mentioned subregional cooperation scheme under the GMS framework. In other words, the only real option for development in Indochina is to pursue subregional cooperation based on the GMS framework through the collaboration of the developed countries, including the Japanese government, with the original ASEAN member countries and countries of the Mekong Basin. The favorable environment created by such developments as the end of the Cold War, the progress of peace in Indochina, the shifting of the socialist countries to a market economy, the Japanese government's aid scheme to Indochina and ASEAN, and economic unity, should be proactively applied to developing Indochina.

4. The Dysfunctional Policy of Traditional Import Substitution

In landlocked developing countries like Laos, the implementation of an import substitution policy has little potential for success. The primary reason is because a mere population of about 5.3 million can only generate so much domestic demand, and it is difficult for import substitute enterprises to achieve merit of scale, although it may depend on the features of the product.

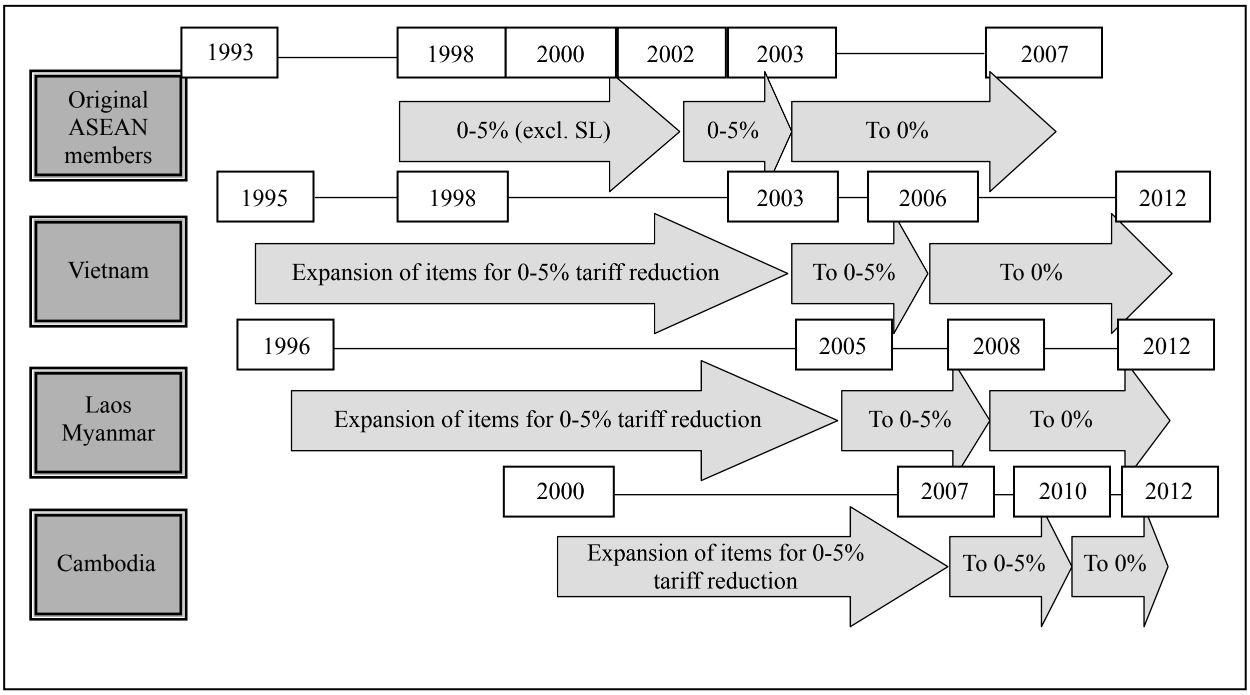
Second, the promotion of import substitutes adversely affects trade balance, because it necessitates the import of capital goods, such as machinery, and intermediary goods, including raw materials and components. Import substitution can be justified if the amount of import of capital and intermediary goods necessary for import substitution is less than the amount of foreign currency saved by the reduced import of completed goods. It is an effective means of increasing employment because products are produced locally, and increased revenue can be expected from corporate tax and income tax. Moreover, it has the added benefit of generating demand for physical distribution and other derived demands. However, with an import amount that is approximately double its export amount, Laos is clearly a country with a large trade deficit, which is a significant fact that limits the promotion of import substituting industrialization.

The third reason is that the new framework of economic unity has made it increasingly difficult to implement traditional tariff policies that many countries had been adopting in their efforts to promote import substitution. Laos became an official member of the Association of Southeast Asian Nations (ASEAN) in 1997, and has since been working to realize the Common Effective Preferential Tariff (CEPT) scheme with an eye to realizing the ASEAN Free Trade Area (AFTA). Laos and Myanmar are planning to reduce the import tariffs of all items excluding those on the General Exception List (GEL) and Sensitive List (SL) to a level between 0 and 5% by 2008 (Fig. 1), and to completely eliminate[1] all import tariffs by 2012. This has made it even more difficult to protect domestic industries by applying high tariffs or to develop import substitution industries. On the other hand, the lowering of tariffs allowed machinery, raw materials, and components to be imported more readily. Yet, in an attempt to compensate

[1] At the ASEAN Economic Ministers' Meeting held September 3, 2004, the members agreed to accelerate the time frame for completely eliminating tariffs in ten areas including automotive items by three years. The deadline for the six original ASEAN members was moved up to 2007, and the deadline for Vietnam, Laos, Cambodia, and Myanmar to January 1, 2012. This agreement was signed at the ASEAN Summit held in November.

for the loss of tariff revenue which is anticipated with the implementation of CEPT, with turnover taxes and excise taxes, the Lao government mercilessly imposes these domestic taxes even on products produced domestically as import substitutes. For this reason, about 20% of a product's cost is ultimately converted to consumers in the form of tax. In other words, the introduction of domestic taxes only served to hamper the development of import substitution industries and other domestic industries (Suzuki 2000).

Fig. 1 Tariff reduction program under the Common Effective Preferential Tariff (CEPT) scheme



(Source) Composed by the writer from materials of the ASEAN Secretariat

The fourth reason for the failure of the import substitution policy is because trade has always occurred naturally and daily among residents living in border regions without their being conscious of national borders. From the perspective of modern nations, this transaction is called border trade, and falls under foreign trade. Like Laos, which is surrounded by five countries, landlocked countries have a long border that makes it extremely difficult to nationally control trade activities. Therefore, any plan to protect domestic import substitution industries with a barrier of tariffs is but an armchair argument. Ironically, the reality is such that motorcycles domestically produced by HONDA Vietnam, for example, must compete with HONDA Thailand motorcycles smuggled into the Vietnamese market (Suzuki 2004, 11).

It must be pointed out that Laos is surrounded by countries that are more economically-developed than itself—China to the north, Vietnam to the east, Myanmar to the west, and Thailand to the south. Although the development of import substitution industries in a landlocked country such as Laos is not completely impossible, achieving success would be extremely difficult.

5. Subregionally Complementary Industrialization Strategy for Landlocked Developing Countries

In the 1960s, TOYOTA Motor Corporation and other Japanese-affiliated firms advanced into Thailand. Thereafter, many more Japanese-affiliated firms expanded into Thailand thanks in part to the deregulation of primary and secondary capitals and the appreciation of the yen following the signing of the Plaza Accord. When a company that engages in the production and assembly of finished products sets up its operations overseas, the supporting parts industry tends to also expand its business overseas in search of a site closer to the parent company. Following this pattern, as many as 5,000 Japanese-affiliated companies are based in Thailand today. Thanks to this concentration of Japanese-affiliated firms, Thailand is now enjoying the growth of a high-level parts industry and the development of human resources. In this way, industries in Thailand requiring large supplies of precision parts and sophisticated technology, such as the automotive and home appliance industries, have come to boast global scale quality and cost competitiveness (JETRO 2004).

However, a subtle change is now occurring among Japanese-affiliated firms that advanced into Thailand. Due to the rise in the costs of labor and production, Japanese-affiliated firms operating in Thailand are now struggling with the issue of cost reduction. Cameras, cellular phones, VTRs and other high-tech products are composed of a large number of lightweight high-tech parts, but this does not necessarily mean that the production of those parts is capital-intensive. Rather, labor-intensive production is frequently a more rational option. As long as this situation is accurately understood, it is possible to elicit new theories of subregional economies that could address the essence of the above-mentioned change. In other words, if the labor-intensive parts production sector that is slowly losing its comparative advantage in Thailand can be shifted to neighboring Laos, it could complement parts production and revive the cost competitiveness of Thailand's parts industry. The parts industry is one that can be bolstered through subregional complementarity between Thailand and Laos. The potential of its integration is explored below.

(1) Advantageous location for the labor-intensive parts industry

The minimum wage in Thailand is 150 baht/day in Bangkok and 138 baht/day in Chiang Mai, whereas it is a mere 50 baht/day in Laos, even when taking fringe benefits into consideration (Suzuki 2004, 9). The difference in wage level is plainly obvious, and clearly indicates that Laos is an appropriate site for the labor-intensive parts industry.

(2) Thai trainers play a core role in the transfer of technology

Even if Japanese companies succeed in making direct advances into Laos, it is far from easy to achieve success under Laos' investment environment. A Lao staff who is not used to speaking in English and a Japanese employee who can understand neither Lao nor Thai would have difficult communicating with each other. However, in this respect, Japanese companies in Thailand have already succeeded in training Thai instructors. Therefore, inviting such Japanese-affiliated companies from Thailand could eliminate the communication problem with the help of the Thai instructors, since the Thai language comes from the same origin as the Lao language, and thereby expedite the transfer of technologies to Lao plants.

(3) On-site training at Thai plants

Lao employees can receive training at their respective company's plant in Thailand. Since Laos and Thailand are physically close to each other, the mobility cost of personnel can be kept low, and since they have similar cultural and linguistic backgrounds, in terms of technology acquisition there is a distinct locational advantage to training Lao workers in Thailand.

(4) Economy of scale and the export market

Parts industries that advance into Laos are long-standing companies that have established and continued to operate plants in Thailand over many years. Invariably, it is the Thai plant, where strategy headquarters is located, that determines which parts are to be manufactured in which country or region within the AFTA framework. Therefore, the subregionally complementary industrialization strategy is not a zero-sum game where the Thai plant is to be closed in its entirety and moved to Laos. Rather, it calls for the production of only the labor-intensive parts from among all parts that are presently produced to be shifted to Laos, and for the manufactured parts to be sent back to the Thai plant. Such a complementary relationship would be beneficial to both countries. For example, labor-intensive parts that constitute high-tech products—the vibrator of cellular phones, microchips for home appliances, trigger coils used in digital camera flashes, wire harnesses and other automotive parts, etc.—would be manufactured in Laos and then sent to the Thai plant, where they will be incorporated with other components. The Thai plant would supply these parts (i) to such companies as SONY, TOSHIBA, HITACHI, and NOKIA located in Thailand, or (ii) to such companies as TOYOTA, HONDA, HINO, and ISUZU, if they are automotive parts producing companies, or (iii) 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 orders for a sufficient lot, and in addition to enjoying merit of scale, it does not need to develop a new export market for the parts manufactured by the Japanese-affiliated companies in Laos. Clearly, the landlocked geographical condition of Laos is not a disadvantage in terms of location.

(5) First and Second Mekong International Bridges

In 1994, the First Mekong International Bridge linking Vientiane, the capital of Laos, and Nong Kai, Thailand, was completed with grant aid from Australia. The Second Mekong International Bridge is being built with yen loan provided by the Japan Bank for International Cooperation (JBIC) between Mukdahan, Thailand, and Savannakhet, a strategic city in southern Laos, and is slated for completion at the end of 2006. Traditionally, goods were transported between Thailand

and Laos by loading a truck with goods and crossing the Mekong River by ferry. However, when completed, the second Mekong International Bridge will connect Thailand and Laos by road just as the first bridge will provide land access between Vientiane and Nong Kai, and it is expected to considerably reduce physical distribution time in the southern areas as well.

(6) Reduction of time and cost spent on logistics (transportation, physical distribution, customs, overhead costs, etc.)

The highway network projects (construction of the East-West Corridor, North-South Corridor, and South Corridor) constitute the core of the Greater Mekong Subregion (GMS) Economic Cooperation framework. It would not be an exaggeration to say that their success depends not so much on the development of necessary infrastructure, but rests largely on the reduction of time and costs for logistics, which include transportation, physical distribution, customs, and overhead costs. First of all, if goods from Thailand to Laos can clear customs in a single day and goods from Laos to Thailand can also clear customs in a single day, the corridors would gain a competitive edge even when compared with the Malaysia-Thailand truck route. Secondly, the time spent on the procedure for importing parts from a subsidiary plant in Laos to the parent company in Thailand must be shortened to within a day. For example, as things stand, 22 different types of documents must be submitted to import a vehicle (Suzuki et al 2002). As such, the streamlining and expediting of export and import procedures to and from Laos forms the backbone of the subregionally complementary industrialization strategy proposed in this paper, and is undoubtedly an issue of paramount importance that must be addressed by the Lao government. JICA can provide technical assistance in the areas of customs and trade operations to help facilitate trade in the subregion by dispatching short and long-term experts to Laos.

(7) Establishment of an export promotion system

Japanese companies in Thailand invited to Laos can enjoy the benefit of reduced import tariffs (0-5%) under the Common Effective Preferential Tariff (CEPT) scheme. However, as previously mentioned, because the application of CEPT will deprive the Lao government of its tariff revenue, it needs to compensate for the loss with two domestic taxes, namely the turnover tax and excise tax, for the time being. A proposal to lower or completely eliminate the turnover and excise tax rates and instead introduce a value-added tax (VAT) is also being considered, but it would not change the fact that some form of domestic tax must be imposed to compensate for the loss of tariff revenue. The Lao government must urgently examine preferential export measures, including a tax system in which no domestic tax is applied to goods that are produced in Laos and exported to Thailand, and create an export promotion system independent of the domestic tax system. In doing so, Laos can learn from the preceding efforts of various Asian countries such as Korea, Taiwan, Singapore, and Thailand. It is indeed in a position to benefit from the latecomer’s advantage in establishing its system. By implementing such an export promotion measure, the Lao government would be able to attain the two major objectives of securing tax revenues and increasing exports simultaneously. JICA can also provide technical assistance for the construction of the export promotion system through the dispatch of short and long-term experts.

(8) Designating the Savan=Seno Special Economic Zone (SEZ) as an "Export Processing Zone"

The Lao government is planning the construction of a Savan=Seno Special Economic Zone (SEZ) in Savannakhet, a strategic city where national highway 13, which runs longitudinally through Laos, and the East-West Corridor intersect. The Savan=Seno SEZ will be divided into two sites. Site A will cover 305 hectares of land adjacent to the second Mekong International Bridge, and is where the financial, commercial, and tourist functions will be concentrated. Site B (20 ha) will be located at the intersection of national highways 13 and 9, and is where warehouses and plants are planned to be invited (Suzuki 2002, 20). The writer feels that inviting the labor-intensive parts industry of Japanese-affiliated companies in Thailand to the Savan=Seno SEZ is the most reasonable means of assuring the success of the SEZ in the landlocked country of Laos.

When inviting companies to the Savan=Seno SEZ, however, at least a part of the SEZ should be designated an export processing zone to allow a strong complementary relationship to develop between Lao plants and Thai headquarters on the cost front. In this zone, products manufactured using raw materials and parts imported from Thailand and other foreign countries are to be exempted from excise tax, turnover tax, and VAT, as described in section 7 above, under the condition that they will all be exported.

For manufacturing trade plants operating outside the SEZ, such as in Vientiane, a refund system of such domestic taxes as excise tax, turnover tax, and VAT should be established and implemented. JICA can provide technical assistance for the development of the export processing zone, its operational methods, and the creation of a tax refund system by dispatching and training short and long-term experts as well as by holding forums.

(9) Can employment numbers be absolutely secured?

Foreign companies employing a large number of cheap labor at their clothing plants and parts plants in Laos speak of the characteristics of the Lao labor market where the rate of employee retention is low and there responses to job openings are weak (Ohno and Suzuki 2000). The employees who work at the plants of foreign companies are almost 100% women, and female workers have made great contributions to increasing the export of industrial products (Mori and Mizuno, ed. 1985, 264). It is believed that Laos will follow the same path as that traveled by developing countries before it. However, there is an idyllic atmosphere to Laos, where many employees quit their jobs at the plant and return to the countryside during the busy farming season. If a chain reaction of foreign direct investment in Laos occurs in search of cheaper manpower, it would become extremely difficult to absolutely secure employment numbers. It is even feared that the lack of labor supply will cause a sudden rise in wages. Suehiro (2001, 264) points out that the rapid industrialization of the Asian countries will not only generate a lack of engineers and specialists, but it will produce a lack of simple labor as well, and it is the temporary workers and foreign workers who could make up for the shortage. Many temporary staff service companies have offices in the area surrounding Hualamphong Central Railway Station in Bangkok, and are busy assigning jobs to young workers from outlying regions. This is a clear indication that a market mechanism that produces additional labor supply functions in the event of a labor shortage. It is only natural that brokers and temporary staff service companies establish offices in Laos to supplement the shortage of labor in Laos as well.

(10) Employment measures are the most pressing issue

However, there is a serious mismatch between excessive labor supply and job type in Laos. Prime Minister Thaksin of Thailand issued a government decree allowing illegal aliens to reside and work in Thailand for a year if they register with labor authorities by July 31, 2004. According to *Voice of America* broadcasted on August 3rd, 2004, more than 180,000 illegal aliens from Laos flocked to the labor office and registered by the deadline. This phenomenon is a clear indication that the Lao labor market is suffering both supply shortage and lack of employment. The primary obligation of the Lao government is to call back migrant Lao workers from Thailand and to provide them with stable employment within Laos (aside from the fact that not all Lao workers returning from Thailand would be suitable workers in Lao plants). Furthermore, according to *Vientiane Time* (2004), an English language newspaper in Laos, of the 3,000 graduates of the National University of Laos this year, 1,500 or half of them were from Vientiane, and only twenty of these 1,500 graduates were able to find employment in government ministries or other civil service jobs. The rest are facing a severe employment situation where they must look for employment by themselves or are confronted with unemployment. Under this situation, the advancement of the Japanese-affiliated parts industry in Thailand to the Lao market would be extremely meaningful in terms of the employment they could create for both simple labor and professional workers.

(11) Establishment of a "Special FDI Mission" under the Prime Minister

In order to pursue the subregionally complementary industrialization strategies described above, it is vital for the relevant institutions to upgrade their functions. Undoubtedly, it is of absolute importance that specialized knowledge and experience is accumulated by the Department of Domestic and Foreign Investment (DDFI) from the perspective of inviting foreign direct investment, by the Ministry of Legal Affairs in terms of developing a legal system, by the Ministry of Commerce in relation to import and export procedures and other areas for trade facilitation, and by the Ministry of Industrial Handicrafts and the Committee for Planning and Cooperation (CPC) in areas pertaining to the establishment and operation of the Savan=Seno Special Economic Zone

(SEZ) and the export processing zone. At the same time, a Special FDI Mission should be created under the direct supervision of the Prime Minister to coordinate these institutions with the objective of providing one-stop service. This effort would also demonstrate Laos' strong commitment to improving the foreign investment environment both internally and to the outside world. JICA can contribute by providing guidance in areas urgently needed in Laos today and in the development of the investment environment through the dispatch of short and long-term experts. The more than 5,000 Japanese companies in Thailand are lacking accurate information on Laos' investment environment. If Japanese experts could make direct visits to the Japanese-affiliated companies in Bangkok or hold investment and business forums in Laos with the cooperation of the Japan External Trade Organization (JETRO), new opportunities will surely open up for foreign direct investment in Laos.

In the "Japan-ASEAN Plan of Action" (2003), Prime Minister Koizumi announced that Japan will place emphasis on (a) cooperation for reinforcing the integration of ASEAN through the Mekong region development and other initiatives, and (b) cooperation for enhancing the economic competitiveness of ASEAN member countries including investment promotion. Prime Minister Koizumi also agreed to enhance support and cooperation for promoting economic and social development in the Mekong region in the "Tokyo Declaration for the Dynamic and Enduring Japan-ASEAN Partnership in the New Millennium" (2003). Not only Laos, but all countries are responsible for the development of their own country, and self-help efforts are expected. Given the end of the Cold War, the establishment of peace in Cambodia, the shifting of socialist countries to a market economy, the expansion of ASEAN, economic unity, and strong declarations for aid by the Japanese government, it is necessary for donor countries, surrounding countries, as well as Laos itself, to recognize anew that the Lao government is in a position to benefit from the framework for subregional cooperative relationship that is taking shape through the efforts of the Asian Development Bank and ASEAN countries.

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4. Prospects of the Motorcycle Sector in the Lao P.D.R.

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Summary

After examining statistical data and comments made by related persons in motorcycle sector in Laos, author has found that yearly demand for motorcycle in Laos has been on increasing trend since the early 1990s, and though it had sharply dropped, for a short period of time during the financial crisis in the late 1990s, as economic recovered, yearly demand quickly got back on its growth trend and has already doubled the level before crisis by 2003. Demand for motorcycle since the early 2000s has been pushed up by relatively cheaper Chinese motorcycle which, in many cases, is imitation of popular models of Japanese motorcycle.

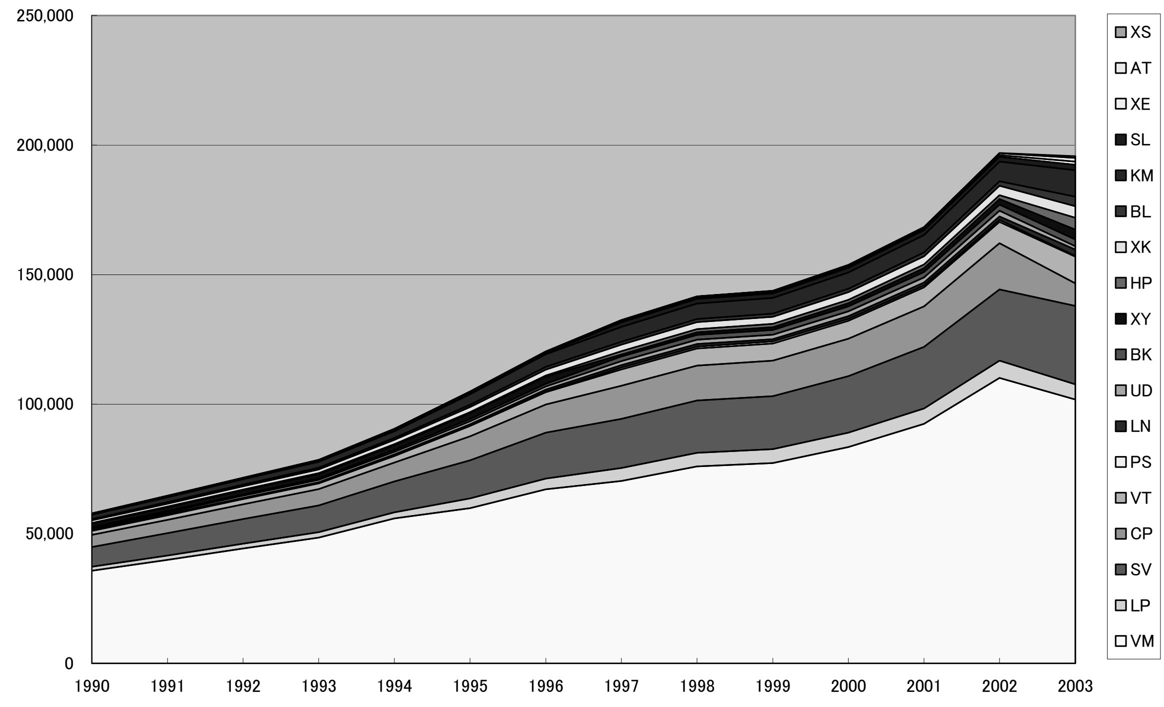
On supply side, the assemble factories of Japanese motorcycle, namely HONDA and SUZUKI have been established and begun operation in Laos since the early 1990s, while most Chinese motorcycle assembler began their operation in the early 2000s. Recently, a Korean-Lao company also began motorcycle assembly and has quickly emerging as one of main competitors in this sector.

Though statistical data available so far reveals, in a certain degree, the much more competitiveness in motorcycle sector of its neighbors especially Thailand, author argues that these does not necessary leads to conclusion that this sector is entirely uncompetitive because motorcycle competitiveness itself may also be created by proper administrations and policies. Furthermore, motorcycle production consisted of multi-level processes and therefore not being competitive as a sector does not equal to being uncompetitive in every levels involved. Author also made a number of policy-suggestions including (1) putting in place policies to encourage existing assemblers to produce more parts locally, therefore promoting development into import substitution industry, but should also leave it to private sector to determine how far they can go, (2) promoting possible development and of supporting industries of motorcycle sector while trying to identify what could be best done locally , partially by channeling some of large sum of its foreign aid to capacity building and human resource development in this sector and (3) continue effort to maintain free and fair competitive environment in motorcycle sector by finding solution to ongoing problem of violation of trade mark and patent rights in order to compensate existing disadvantage and make Laos a more attractive place for foreign direct investment..

Introduction

Motorcycles, including bicycles with a simple engine, were imported to Laos as early as the 1950s. Motorcycles in Laos were mostly dominated by those with 50cc engine[1] until the middle of 1980s, when those with a 70cc engine, or a real motorcycle by international standards, began to be available to general public of Laos. Motorcycles had been the main means of transportation for the relatively wealthy civil servants and merchants in the big cities, especially Vientiane municipality, until late 1980s when some high-school students began to ride motorcycles to schools. By the late 1990s, with much cheaper Chinese motorcycles beginning to flush the Lao small domestic market, and with the prices as low as almost one third of Japanese motorcycles assembled locally or from Thailand, motorcycles suddenly became within the reach of general public. Nowadays it is already difficult for one to see people riding bicycles in downtown Vientiane, except during rush hours when most pupils of up to lower secondary schools ride bicycles to schools.

Graph 1　Registered Motorcycle Numbers by Provinces



Note: refer to foot note for the meaning of abbreviation of the name of provinces[2].

Source: Ministry of Communication, Transportation, Post and Construction

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[1] According to a person who was a student at school during the 50s, there were also a few Harley-Davison motorcycles on the streets of Pakse and Vientiane as early as 1955.

[2] VM: Vientiane Municipality or Vientiane Capital, LP: Louangphabang, SV: Savannakhet, CP: Champasak, VT: Vientiane, PS: Phongsaly, LN: Louangnamtha, UD: Oudomxay, BK: Bolikhamxay, XY: Xayyabouly, HP: Houaphanh, XK: Xiangkhouang, BL: Bolikhamxay, KM: Khammouan, SL: Salavanh, XE: Xekong, AT: Attapeu, XS: Xaysomboun Special Zone.

Until the early 1990s motorcycles were mainly finished products imported mostly from neighboring Thailand. Laos began to assemble motorcycles domestically in early 1990s with the establishment of simple assembly lines for HONDA and SUZUKI motorcycles by investors from Japan and Thailand. Kolao, a Korean company (or a company founded by a Korean national) in Laos also began motorcycle assembly in 2003, adding more choices for the Lao people besides the high-end Japanese motorcycles and low-end Chinese motorcycles.

The number of motorcycles in Laos increased steadily from about 50,000 in 1991 to almost 200,000 in 2003 as shown in Graph 1. Though still far from being a successful development of an import-substitute industry, the motorcycle sector has so far been moving towards this. Starting from import finished motorcycles from Thailand, there are now more than a dozen factories in the country assembling more than 5,000 motorcycles per month during the period from February 2002 to June 2004, already making this a major sector in the national economy by Lao standards. New Chip Xeng which assembles HONDA motorcycles also began to make efforts to increase local content after long stagnation in sales due to market entrance of Chinese motorcycles, which are often imitations of already popular models from HONDA, bringing Laos a few steps closer to producing, and not just assembling, motorcycles.

Progress was made not only on the supply side, but also on the demand side. People respond quickly to the rise and fall of the prices as could be seen with Chinese motorcycles, which did not sell at all when first introduced to Laos with prices only slightly cheaper than Japanese motorcycles. Chinese motorcycles began to sell well when the prices were reduced to about 1/3 of Japanese motorcycles. However, Japanese motorcycles did also make a great comeback, as can be seen by the price cut of the popular model of HONDA, which made many people who were ready to compromise on quality for price to rethink. HONDA's price cut has reduced the number of Chinese motorcycles one could buy for the money needed to buy 1 Japanese motorcycle from 3 to about 2. This means that presently, consumers in the motorcycle sector in Laos could respond not only to prices, but also to quality. This is rare in Laos where usually it is suppliers who have the say on what the prices should be and consumers have next to nothing when it comes to information on the quality of the products they buy.

The purposes of this report are to make an analysis of development so far, as well as the present condition of the motorcycle sector in Laos from both the demand and supply side perspective, before attempting to evaluate prospects of the sector and lastly to make a few recommendations on what the Government of Laos can do to promote this sector.

Demand Side of the Motorcycle Sector in the Lao P.D.R.

Table 1 shows the number of yearly newly registered motorcycles in Laos from 1991 to 2002. Demand for motorcycles in Laos has been consistently high since the economy began on its growth track in the late 1980s, or a few years after the New Economic Mechanism was put in place. Yearly demand for motorcycles was around 10,000 units in the early 1990s and grew to about 17.000 units in 1996. Demand for motorcycles decreased during the period between 1997 and 1999 when a financial crisis hit the region. Demand for motorcycles in 1999 drop sharply to only about 4,000 or less then 1/4 of the demand level in 1996. As the Lao economy recovered from the crisis, the demand for motorcycles also began to recover in the year 2000. Demand for motorcycles reached the level of more than 10,000 units again in 2000, about 16,000 in 2001 and achieved a yearly increase of almost 100% to more than 30,000 in 2002. Yearly demand for new motorcycles stands somewhere around 60,000 units in the year of 2004[3].

Motorcycles sold in Laos before the financial crisis were practically all Japanese, especially those from HONDA and SUZUKI which have local assembly factories since the early 1990s. However, from late 1990s, factories assembling Chinese motorcycles came to existence. During the period from February 2002 to June 2004, out of about 150,000 units of motorcycle parts that were imported to Laos, only about 2% or 3,500 units were of Japanese brands. Assuming that the imported numbers are equal to the numbers that were sold in the same period, and by considering the fact that demand for motorcycles before the crisis were practically all Japanese and stood at the level of 10,000 units per year, one may safely say that during this period Japanese motorcycles have lost more than 80% of its yearly demand to cheaper Chinese motorcycles. Moreover, with the yearly demand for motorcycles being about 30,000 in 2003 compared to only about 10,000 during early 1990s, one may also safely say that Chinese motorcycles have expanded the motorcycle market in Laos to more than 3 times in the year of 2002 from its original size in early 1990s.

As stated above, entry to the market of Chinese motorcycles made motorcycles something within the reach of general public people. Even some people in rural areas are now riding motorcycles, especial cheaper Chinese motorcycles, to work or to schools. In a country where a relatively small number of people living scattered throughout mostly mountainous areas, motorcycles can be a very handy transportation tool for people who still cannot afford their own cars. By taking into account the fact that per capita cost of installation of a mass transportation system would be relatively high in Laos for the same reason, motorcycles are still likely to remain as one of main means of transportation for many people in Laos in the years to come.

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[3] Rough estimated by author according to the fact that 5,000 units are assembled on average every month during the period from February 2002 to June 2004.

Table 1 Number of Newly Registered Motorcycles in each Province

No.	Province	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1	Vientiane Capital	4212	4350	4217	7423	3922	7237	3244	5631	1338	6130	9007	17636
2	Phongsaly	11	11	11	N.A.	8	23	571	16	4	17	25	49
3	Louangnamtha	35	36	33	57	71	283	104	46	11	51	74	145
4	Oudomxay	75	77	79	129	155	162	264	100	26	109	161	314
5	Bokeo	53	55	53	102	124	155	803	72	17	78	115	226
6	Louangphabang	176	182	180	302	1424	445	788	236	56	256	377	737
7	Xayyabuly	143	149	148	242	401	402	N.A.	194	44	211	309	606
8	Houaphanh	28	29	27	48	49	76	743	37	8	41	60	117
9	Xiangkhouang	123	127	123	215	258	345	289	164	38	179	263	514
10	Vientiane	191	197	221	351	1456	768	1533	255	60	278	409	806
11	Bolikhamxay	59	62	63	95	122	145	112	79	18	86	127	249
12	Khammouan	197	203	199	353	1464	760	861	263	62	286	420	823
13	Savannakhet	903	933	874	1563	2810	2918	1329	1209	287	1316	1934	3788
14	Salavanh	21	21	22	36	42	61	1357	27	7	30	44	86
15	Champasak	544	562	536	959	1958	1669	1913	727	178	792	1163	2278
16	Xekong	18	18	18	31	36	30	128	24	5	25	37	71
17	Attapeu	27	N.A.	108	48	55	N.A.	75	36	8	40	58	114
18	Xaysomboun	N.A.	N.A.	N.A.	N.A.	7	48	11	10	1	10	15	31
	Whole Country	8807	9004	8905	13948	16357	17523	16122	11124	4167	11935	16599	30592

Source: Computed by author from data provided by Ministry of Communication, Transportation, Post and Construction.

Demand for motorcycles in Laos not only come in the form of a necessity as a means of transport, but in a country like Laos where having a savings account at the bank is still rare, a motorcycle is also a durable consumer good that costs at least as much as a person's average yearly income (per capita income in Laos fluctuated around $300 in recent years). Therefore, buying a motorcycle is also among the most popular means of saving, together with buying gold, land, cars and others.

Table 2 Motorcycle Owning Rate in 1999[unit / household]

Vientiane Capital	0.869
Phongsaly	0.028
Louangnamtha	0.048
Oudomxay	0.047
Bokeo	0.086
Louangphabang	0.083
Xayyabuly	0.020
Houaphanh	0.036
Xiangkhouang	0.074
Vientiane	0.128
Bolikhamxay	0.042
Khammouan	0.116
Savannakhet	0.180
Salavanh	0.038
Champasak	0.157
Xekong	0.042
Attapeu	0.028
Xaysomboun	0.010

Sources: (1) State Planning Committee, Basic Statistics of Lao P.D.R. 1975-2000.
(2) Ministry of Communication, Transportation, Post and Construction

Table 2 shows owning rates of motorcycles per household in Laos in 1999. As can be rationally expected, in 1999, people in the 4 big provinces of Vientiane Capital, Savannakhet Province, Champasak Province and Vientiane Province were those with the highest owning rates at 0.87, 0.18, 0.16 and 0.13 respectively. The rest had less than 0.1 with the exception of Khammouan which had 0.12 motorcycles per household. It was also a little surprising to see that Louangphabang, the former capital city, fall behind Khammouan with only 0.09 motorcycles per household.

In 1999, only Vientiane Capital had nearly 1 motorcycle per household. However, the number should be higher now since the number of registered motorcycles in Vientiane in 2003 was 101,812 units compared to only 77,338 units in 1999. Motorcycle numbers in Vientiane Capital has been increased 8% per year during this period. On the other hand, the motorcycle owning rates in other provinces were still very low. Savannakhet Province which had the highest owning rate after Vientiane Capital had only about 1 motorcycle in every 5 households. Other large provinces such as Champasak and Vientiane also had only about 1 motorcycle in every 6 households. This means that in the large provinces alone, a 500% increase is needed in order to push the motorcycle owning rate up to the same level as that of Vientiane Capital.

Table 3 Number of Motorcycles per 1000 in each Province

No.	Province	Motorcycles per 1000 persons		
		1995	1999	2003
1	Vientiane Municipality	113	133	156
2	Phongsaly	1	4	2
3	Louangnamtha	5	8	17
4	Oudomxay	5	7	5
5	Bokeo	7	15	19
6	Louangphabang	10	13	13
7	Xayabouly	8	3	10
8	Houaphanh	2	5	15
9	Xiangkhouang	9	12	18
10	Vientiane	14	21	28
11	Bolikhamxay	5	7	18
12	Khammouan	15	20	30
13	Savannakhet	22	27	36
14	Salavanh	1	6	6
15	Champasak	18	24	14
16	Xekong	4	6	15
17	Attapeu	5	5	13
18	Xaysomboun Special Zone	0	1	14
	Whole Country	23	29	35

Sources: (1) State Planning Committee, Basic Statistics of Lao P.D.R. 1975-2000.
(2) Ministry of Communication, Transportation, Post and Construction

Since the number of households is not available in a time series, I would also like to take a look at the motorcycle owning rate for every 1,000 persons as shown in Table 3. In Laos, every 1,000 persons owned 23 motorcycles in 1995, the figure increased to 29 in 1999 and 35 in 2003. The same figure is much higher in Vientiane Capital which has 156 in 2003 for every 1,000 persons. This 156 per 1,000 persons is 3 times than the figure for mainland China, but 1/3 of that for Taiwan[4].

In short, by looking at the present number of motorcycles in Laos, as well as in each province, there is still likely to be much room left for growth of demand for motorcycles throughout Laos. As long as there is demand, supply must be made to meet this demand in one way or another. Prior to the early 1990s, this demand used to be met by the importation of finished products from Thailand, when Japanese motorcycle assembly factories were established. In Laos, it seems to be a choice somewhere between importing finished motorcycles and making efforts to produce them locally. Laos started from the former and has so far made some progress towards the letter since the early 1990s. It is of course not clear at moment which one will be best for the Lao economy in the long run, but increasing local value-added production as much as possible seems to be what Laos can do to meet the demand for motorcycles in a way that costs the national economy less at least in a few years to come.

Supply side of Motorcycle sector in the Lao P.D.R.

In the Lao P.D.R., before 1990 it was practically only motorcycles that were imported as finished products from abroad. Santhiphab SUZUKI, a factory which assembles SUZUKI motorcycles, was establish in 1990 followed by New Chip Xeng, a factory which assembles HONDA motorcycles, in the following year or 1991. Though at the beginning, what both factories were doing was just simple assembly tasks, this was undoubtedly the beginning of supplying motorcycles that were being made as finished products locally in the Lao P.D.R. Many factories assembling Chinese motorcycles were established during early 2000s and according to data provided by the Ministry of Communication, Transportation, Post and Construction, there are now 14 factories that had been actively assembling motorcycles of Japanese, Chinese and Kolao (Korean-Lao) brands in the Lao P.D.R. during the period from February 2002 to June 2004. These factories are as follow.

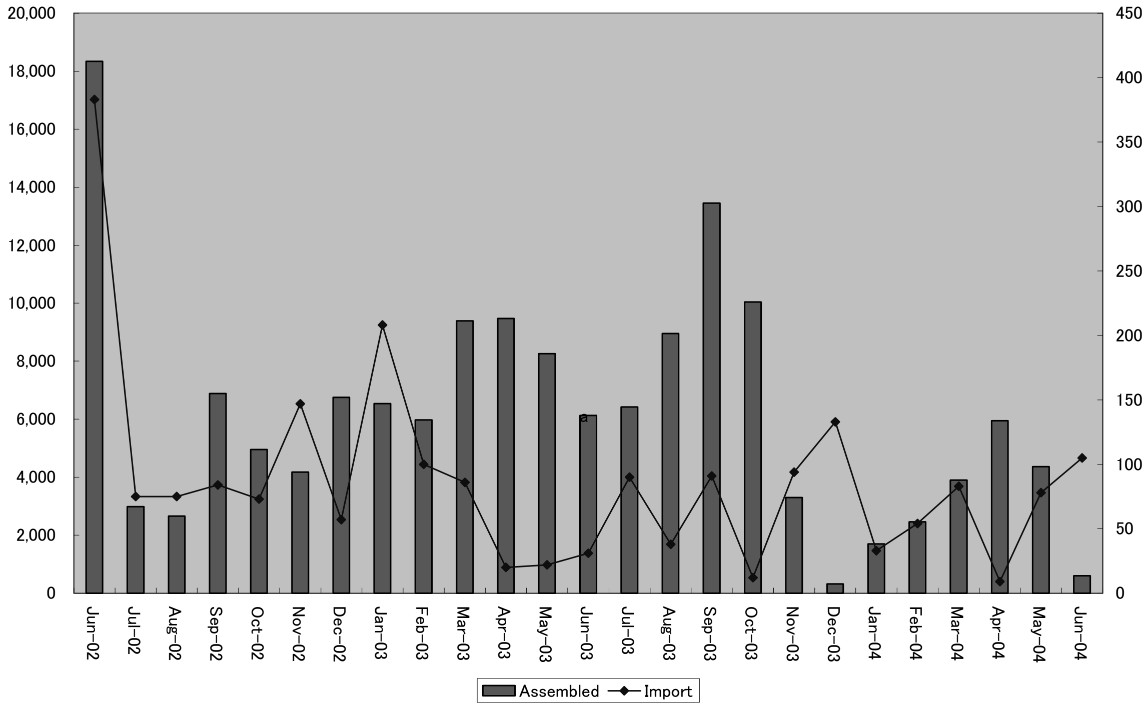
1 Angkham Vehicle Assembling Factory
2 Chongseng Vehicle Assembling Factory
3 Chuli Vehicle Assembling Factory
4 Dongchong Vehicle Assembling Factory
5 Hoching Vehicle Assembling Factory
6 Khamkeo Vehicle Assembling Factory

[4] According to China Daily March 21, 2002 (electronic version), Motorcycles owning rate for every 1000 persons in China is 50 while in Taiwan the number is about 500.

7 Leuangfathong-Yada
8 New Chip Xeng
9 Samsing Vehicle Assembling Factory
10 Santhiphab SUZUKI
11 Sengtavan Motor Vehicle Assembling Factory
12 Sintham Industry Vehicle Assembling Factory
13 SP Factory Municipality
14 Thongpong Vehicle Assembling Factory

Number 8, New Chip Xeng and number 10, Santiphab SUZUKI are those that assemble Japanese motorcycles, namely HONDA and SUZUKI respectively. The rest seem to be those that assemble Chinese motorcycles. Of course, as widely known and a problem in many countries, many of these cheaper Chinese motorcycles are imitation products of Japanese motorcycles in terms of design and name. This means that most Chinese motorcycles look very similar to Japanese motorcycles and also have names that make it difficult for people to distinguish them.

Graph 2 Number of Motorcycles Assembled and Imported during February 2002 to June 2004



Source: Ministry of Communication, Transportation, Post and Construction

Before 1990, as there were no motorcycle assembly factories in Laos, all newly registered motorcycles must have mostly been those imported to Laos as finished products. The number of imported finished motorcycles gradually decreased since then and during the period from February 2002 to June 2004, on average, there were 70 motorcycles being imported to Laos per month as finished products compared to almost 5,000 being assembled per month during the same period.

According to an executive of one of the Japanese motorcycle assemblers in Laos, before Chinese motorcycles that were also mostly imitations of Japanese motorcycles entered Laos, HONDA and SUZUKI held up 70% and 30% of Lao motorcycle market respectively. But after cheaper Chinese motorcycles entered local market, HONDA and SUZUKI motorcycles' share were reduced to less than 1%. HONDA used to sell around 1,000 units monthly but that figure decreased sharply to only 40 to 50 units per month. However, after HONDA took a decisive step to reduce the price of the WAVE100, the most popular model, from 52,000 Baht to about 35,900 Baht (or about $1,333 to about $920), HONDA took up 70%, Kolao 20% and Chinese motorcycles 10% of the newly sold motorcycles market in Laos, during the period from June to August 2004. Before June 2004, HONDA sold only 30 to 40 units a month, but after June 2004 the number shot up to 800 to 900 units per month.

Since data on assembled motorcycles by factories in Laos were available only up to June 2004 which was also the time when HONDA entered the price reducing war with Chinese motorcycles, it is therefore currently impossible to verify the above comment with data. However, this can be verified partly by disappearance of many Chinese motorcycle shops in the city of Vientiane during the second half of 2004, and the fact that HONDA imported parts for 600 motorcycles in June 2004 alone, compared to only 1,500 from February 2002 to May 2004.

Motorcycle assembly in Laos started with the establishment of factories assembling Japanese motorcycles under the CKD[5] system. Now HONDA, many Chinese motorcycle assemblers and Kolao are operating under the IKD[6] system. Tariff rate for the IKD system is lower then for CKD, and under the IKD system, value-added local production must be higher than a certain level. Japanese motorcycle assemblers began with the CKD while many Chinese motorcycle assemblers started or quickly shifted to IKD system. Though the IKD is more desirable because it brings more income to the country, it may not be entirely fair in discriminating factories that are still reluctant to change if they were accepted to operate under the CKD system in the first place. Moreover, with the present situation where many Chinese motorcycles sold locally seem to be violating patent as well as trademark rights of Japanese motorcycles, especially of HONDA, as has been in the case in Laos, it is a distortion of fair competition and needs to be put right.

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[5] Under CKD or Complete Knock Down system, importer will import a complete motorcycle parts that can be assembled to complete motorcycle again locally. Under this system, local value-added production is reduced to minimum level of those from assembling works.

[6] Under IKD or Incomplete Knock Down system, importer will import incomplete motorcycle parts to assemble, as well as add any necessary works to make a complete motorcycle with the condition that local value-added production must be higher than a certain level.

Though it still cannot be confirmed by data provided by Lao authority, Kolao, which has already been a famous company in Laos by selling small secondhand HYUNDAI trucks and KIA cars in Laos, is another motorcycle assembler that needs to be mentioned here. As has been mentioned in the comment made by an executive of a Japanese motorcycle assembler above, motorcycles assembled by Kolao under the Kolao brand has already been available to local people for a while with the reputation of being a motorcycle as a 3rd choice, between expensive but high quality Japanese motorcycles and cheap but low quality Chinese motorcycles. Besides being regarded by the Lao authority as being among the top in terms of value-added local production, Kolao also had been very aggressive in its effort to build up its brand and presence in Laos. The many small Kolao franchise shops that can be seen in downtown Vientiane Capital are among the efforts made by Kolao at the moment.

Graph 2 and Table 4 reveals the numbers of motorcycles assembled by these factories during the period from February 2002 to June 2004. The top five factories that assemble Chinese motorcycles already hold more than 85% of all motorcycles assembled in this period. New Chip Xeng and Santhiphab SUZUKI which assemble HONDA and SUZUKI motorcycles assembled only 2% of the motorcycles assembled during this period. Though New Chip Xeng, as it has claimed, seems to have gotten much of its market share back during the last 6 months of 2004, that seems to be the case only in big city like Vientiane Capital where income level is relatively high. Chinese motorcycles still seem to sell well in Laos. According to Vientiane Times (Wednesday, March 16, 2005) Sintham Industry Vehicle Assembly Factory states that its motorcycles are still sold well and that it is considering increasing its motorcycle assembly from the current level of 4,000 units per month to 6,000 units per month next year. There are still more than 9 months before next year, so putting aside that 6,000 units per month, 4,000 units per month is still quite a volume and can be an indication that Chinese motorcycles are still sold well in Laos.

Table 4 Assembled Motorcycles by each factory during February 2002 to June 2004

No.	Company's Name	Units
1	Sintham Industry Vehicle Assembling Factory	35,577
2	Chongseng Vehicle Assembling Factory	27,771
3	Dongchong Vehicle Assembling Factory	27,651
4	Chuli Vehicle Assembling Factory	19,520
5	Hoching Vehicle Assembling Factory	15,400
6	Leuangfathong-Yada	7,321
7	Khamkeo Vehicle Assembling Factory	7,080
8	SP Factory Municipality	2,970
9	New Chip Xeng (HONDA)	2,100
10	Santhiphab SUZUKI (SUZUKI)	1,412
11	Samsing Vehicle Assembling Factory	900
12	Thongpong Vehicle Assembling Factory	900
13	Angkham Vehicle Assembling Factory	660
14	Sengtavan Motor Vehicle Assembling Factory	150

Source : Ministry of Communication, Transportation, Post and Construction

At the moment, it is not clear whether the motorcycle sector in Laos will develop into a successful import substitution industry. It is still very difficult to foresee whether Laos has a comparative advantage in this industry, especially after economic integration such as the implementing of the AFTA and other upcoming trade agreements. Finally, it is up to private companies to decide whether development of this industry in Laos is possible or not. The Lao government may encourage that what is good for Laos and may not be good for others, as long as it does not violate what has been agreed upon internationally.

In short, in the supply side of the motorcycle sector in Laos, at the moment there are various factories assembling Japanese, Chinese and Korean (or Lao-Korean since there is no Kolao motorcycle in Korea) motorcycles. New Chip Xeng, which assembles HONDA motorcycles, has already entered the price reduction war with Chinese motorcycles by trying to lower procurement costs and increase value-added content produced locally, while Santhiphab SUZUKI, which assemble SUZUKI motorcycles, is still hesitating to take any action. Kolao entered this sector recently with the price and quality in between Japanese and Chinese motorcycles (as one of its executive has claimed). Kolao will surely be a threat to Japanese and Chinese motorcycle assemblers. An unfair competitive environment because of violation of patents as well as trademark rights is also something the Lao government needs to carefully and actively cope with.

Prospects of the Motorcycle Sector in the Lao P.D.R..

Though in market economy, it is the private sector that will ultimately have to decide what can and can not be done. However, in a market environment where free and fair competition is still something far from reality, a certain level of intervention cannot be entirely avoided. Of course intervention here must be bounded by rule of law and commitment Laos has made internationally. Only few, if any, government in the countries denying utilization of centrally planed economic system, can fully deny having drafted any plans at all. Most developing economies have or at least are trying to have ones. Which industries will (or should) be the growth engines is something that should be stated [Kenichi Ohno: 2004]. Of course this does not apply that it cannot be changed once decided. Plan can be more than one and can be flexibly changed accordingly. Moreover, this should not be, by any mean, picking up or committing to a particular sector. In present situation where neighboring countries are working hard to plan their paths to prosperity, Laos also needs to have ones. With limited resources in limited time, Laos needs to carefully choose which industries could be its growth engines, and channel its limited resources to strengthen competitiveness of such industries by way of helping them to strengthen their competitiveness.

However this is certainly difficult task for Laos, where availability of statistical data is next to none and policy making capability of the government is still limited. Though many methodologies exist for calculation of competitiveness, looking at competitiveness by categorizing them into individual industries may not reveal true dynamic comparative advantage of a country [Kenichi Ohno:2004]. It may not be accurate to judge whether an industry is entirely competitive or not because in some industry there are many products and processes involved, therefore competitiveness will depend, among other things, on production management capability and appropriateness of policies including tariff rates [Kenichi Ohno:2004].

In the meantime, Laos is, by all means, one of the battlegrounds for Japanese and Chinese motorcycles. So far in Southeast Asia, Chinese motorcycles, which were also mostly imitations of Japanese motorcycles, have been successful, taking much of the market share, as well as increases in size of the markets in Laos and Vietnam. In Indonesia, though Chinese motorcycles can sell around 200,000 units annually, 90% of the market still remains in the hands of Japanese motorcycles [Kohei Mishima:2004]. Thailand, where Japanese motorcycles still hold 95% of the market, is the market where Chinese motorcycles failed to penetrate [Kohei Mishima:2004]. Therefore, Laos, is the frontline as well as battleground of the battle between Japanese and Chinese motorcycles. The strength of Japanese motorcycles is certainly the quality, while Chinese motorcycles have the price advantage. Both will certainly work hard to catch up with one another's strength. Though yearly demand for motorcycle in Laos in 2002 stands at about 30,000 units, the supply side has been assembled 5,000 units per month during the period from February 2002 to June 2004 and one of assemble factory alone have declare that it will increase its monthly production to 6,000 units. And if this is the case than yearly demand for motorcycle in Laos could reach 100,000 units in no time. Though this is still far less than 1,327,675 units in Thailand (2002) [Mitsunori Yokoyama:2003], about 1.3 million in Vietnam (2003) and about 3 million in Indonesia (2003) [Kohei Mishima: 2004], one must not forget that economic integration not only mean that Laos will have to open its local market to its neighbors, but for the same reason the multiple times bigger markets of its neighbors will also available to Lao products to challenge. Therefore it will be incorrect to take it for granted that foreign investors investing in Laos will have to be limited to only tiny domestic market.

Any policies concerning the motorcycle sector in Laos will have to take the above fact into consideration. Sadly, Laos had been a strategic location and battle ground during the war in the last century, and there is no reason why it can't also be a strategic location for the ongoing economic one as well. Moreover much more intense economic battles will certainly break out as economic integration progresses. It is true that after economic integration, Laos risks losing chances to industrialize many of its potential sectors. However, economic integration within the region, as well as with some of the economic powers has already been the trend, which is difficult to reverse. Laos managed to come this far by opening up its economy. Therefore the reverse seems to be unthinkable at the moment.

Industrialization may be realized by either the local development of existing technology or technology adopted from outside. Laos does have potential for industrialization from inside in many sectors such as the agricultural sector, sericulture sector, as well as traditional handicraft sector. However, if Laos is to survive the upcoming economic integration, it also needs to adopt new advanced technologies from abroad. One of the reasons that Chinese motorcycles could not penetrate the Thai market was the fact that Thailand did not just assemble Japanese motorcycles, but they could develop motorcycles under the Japanese brand from scratch, using parts produced locally [Kohei Mishima:2004]. In Laos, HONDA has been trying to increase local contents after shifting to the IKD system recently. Though it is not clear whether the calculation was made according to the value-added or the number of parts, Sintham industry, a Chinese motorcycle assembler in Laos, stated that 40% of parts of its motorcycles are now produced domestically, and that though it might produce all the necessary parts itself, it chose not to do so because import duties on finished parts and raw materials needed to make the parts were almost the same [Vientiane Times: March 16, 2005].

The number of newly registered motorcycles in Laos was about 30,000 units in 2002; this means that the motorcycle sector had already become a sector which has a yearly value of at least $15 million[7]. If all factories operate under the IKD system, value-added of local production would already be about $3 million. Of course the actual figure could be much higher since the related sectors such as repairing and parts shops also generate income. This sector has already become an industry by Lao standards, creating jobs for local people, and accumulating know-how to a certain extent.

Presently, local demand for motorcycles is high and it is expected to be higher in the years to come, while motorcycle companies from various countries are competing intensely in the local market. If Lao is where it was a few decades ago, it would not be difficult for Laos to develop this sector by protecting it from competition from outside. However, with Laos being less than 3 years from fully complying with AFTA conditions, and in the process of trying to become a member of the World Trade Organization, as well as preparing to be integrated into a few other economic blocks, it is almost impossible for Laos to develop sectors with no former comparative advantage by way of protecting and fostering.

However, I believe there are things which Lao government can do to promote this sector at the moment, regardless of whether this sector will be develop into an import substitution sector or not. These are as follows.

(1) Encourage local motorcycle assemblers to further shift to the IKD system as much as possible and let them decide how far they could go.

The present shifting to the IKD trend is somehow the result of government policies combined with rational decisions by private companies. And for Laos it is natural to say that the greater the shift to IKD, the better because Laos will be richer by the local value-added created by this shift. Private companies will continue to shift to IKD as long as doing so still make sense, however, the government

[7] This amount can be obtained by multiplying the 30,000 newly registered motorcycles by $500 which is the price of cheaper Chinese motorcycle.

also needs to make it clear what its intention is on this matter. Though it is still difficult to decide whether development of this sector locally is viable, the government should, and could at the moment, be encouraging private companies to move in this direction and let them decide how far they could go.

Price of cheap model of HONDA and SUZUKI motorcycle in Thailand is about $ 688 (1$ = 40 Baht) and $745 respectively [Mitsuru Yokoyama:2003]. These prices are already lower than present cheap model of HONDA motorcycle and only slightly more expensive than average Chinese motorcycle in Laos. This seems to be one of determinant factors why Chinese motorcycle failed to penetrate Thai market. Actually this seems also to be the reason while many economists are reluctant to confidently say that Laos should try to develop this sector into import substitution industry. It is true that if HONDA motorcycle of $ 688 can be imported from Thailand without or with very low import tariff, it may seem non sense for someone to try to assemble a HONDA motorcycle locally.

However, one must also not forget that the present price of the same model of HONDA motorcycle assembled in Laos which stands at about $ 900 also includes import tariff on parts. Moreover, average wage level in Laos is certainly cheaper than that in Thailand. According to a Japanese factory which has moved some of their production lines to Laos, monthly wage of a worker in Thai factory is about 6,000 Baht or 3 times higher than only 2,000 Baht in Lao factory. Per capita income in Laos is between $ 300 to $ 400 or less than 20% that of Thailand. Though the number of available labor force is much smaller in Laos, I believe that for a few years to come it will still remain lower than that of Thailand. If this is the case, and if one takes no account of transportation costs of parts to assemble factory which seems to be higher in Laos on average since ,in the mean time, only few parts can be produced locally, than a $ 688 HONDA motorcycle assembled in Thailand can possibly be cheaper by the difference of the wages. Besides Japanese motorcycle assemblers, Chinese motorcycle assemblers and Korean-Lao motorcycle assembler will also try to improve the quality and lower the price of their products assembled in Laos.

Therefore I personally do not believe that it is absolutely impossible for motorcycle industry in Laos to be developed into an import substitute industry and hopefully to an export industry in the future, though it is also unlikely to be so in the mean time. Consequently, I think the government should try to encourage existed local assembler to further shift to IKD, therefore increase local value-added production and let the private sector decide how far they can go.

Though fostering an industry by protecting it from external competition is something already out of date, no one can deny that most industrialized nations have done so in the past in one or other way, with some even fostering its industry by protecting them from external competition by utilization of military might. Though the time before Laos needs to fully (or almost fully) comply with regulations based on free trade principle is not much, but before that actually happens, Laos is still legally and fully entitled to some protection means even those that may be not allowed after obligation fulfillment. Fostering industry is a matter of national interest, therefore Laos can and should do what ever it can as long as that does not violate laws as well as its agreements with international community.

(2) Encourage assemblers to improve quality of parts produced locally, possibly by conducting training by foreign experts

It is private companies that will have to decide what can be better (as well as cheaper) done where. Some motorcycle assemblers produce some of necessary parts locally because it is worth doing so. On the other hand, competing between countries in manufacturing finished goods would be more and more difficult as economic integration advances. However even if Laos has no comparative advantage in producing motorcycle as a finished product, it still does not necessary mean that there is nothing Laos can do in many processes involved. Producing a finished electronic appliance or an automobile require a number of processes. Making effort to identify which processes Laos has or potentially has comparative advantage is also what the government can do.

It is widely believed that given the differences of preconditions between Laos and its neighbors, it is difficult or impossible for Laos to develop industries by repeating what Thailand has done in the past. If this belief is right then Laos needs to look for other alternative. Though it is still early to suggest that aiming solely to become the center of supporting industries is the way for Laos, it surely is one of already few options it could take. Both Thailand and Vietnam have managed to realize high-growth by utilizing foreign direct investment. Building supporting industries has often been raised in countries accepting foreign direct investment.

These supporting industries are now facing with rising wage problem in Thailand, while Vietnam is now trying to build ones to support its already booming foreign investment. At the same time, Laos is in the process to be integrated into a regional economic block which includes both countries. Making effort to develop potential supporting industries is then one of possible option for Laos to industrialize its economy. However, supporting industry often need a certain level of skills, while these skills are those that have been accumulated over the long period of time in other industrialized and developing countries.

Consequently building necessary skills needed for development of supporting industries from scratch by relying solely on local accumulation could be difficult and time consuming. In present condition where its neighboring are making progress Laos has almost no time to spare. Therefore in a country like Laos where a large sum of foreign aid is available, actively making attempts to channel as much of this aid into building the capacity of the country for producing higher quality parts and therefore making the country indispensable for many others should be considered a wise move.

(3) Make efforts to attract parts-makers to move their production base for parts, which will have as great a comparative advantage of producing in Laos as possible

Though the goal is similar to (2), (3) can be more sufficient. With the present situation where thousands of parts-makers are operating in neighboring Thailand, whose language and culture are almost identical to that of Laos, appealing to them directly about merits of moving and about what can be done better (or cheaper) in Laos can be effective. The advantages for similarity of the culture and language are as follows. Firstly, similar culture means that most of business practices which these companies have developed or adapted to in Thailand seem to be also useful in Laos. Secondly, speaking almost the same language[8] means foreign staffs who have managed to learn Thai language or local (in this case Thai staff) staff will not have to overcome any language barrier in dealing with Lao workers.

HONDA began its motorcycle production in Vietnam in 1998 []while joint venture companies established locally in Laos began to assemble HONDA and SUZUKI motorcycle from early 1990s. The difference here is that local assembler in Laos was not a moving factory abroad by HONDA and SUZUKI themselves. However these were the advancement by HONDA and SUZUKI in Thailand. Though culture and language alone cannot be determinant factor in determination of investing places, these are example of merit of low cultural and linguistic barrier.

In the years to come, Thailand and Vietnam are likely to become supply center of many consumer goods includes electronic appliances and automobiles. Even in the same country where almost identical regulations are applied, makers still need to procure parts from parts makers. Junichi Mori et all [2004] has also reasonably stated in his research on Vietnam that “To remain competitive under globalization and regional competition, the best parts from any location in the world, especially East Asia, must be wisely combined rather than aiming at 100% localization”. Geographically, Laos is the ideal place to produce parts and supply to makers in Thailand and Vietnam. Limited domestic labor force, lack of skilled labor and undeveloped industry seems to be among those preventing this from happening. However, Existence of problems does not automatically mean that this is not possible in Laos. On the other hand, getting rid of these problems will be the prerequisite. Therefore what the government can do here is to try to precisely locate the problems and make effort to eliminate them while attempting to encourage parts makers in neighboring country to move what is viable to Laos.

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[8] It is widely known that most of Lao and Thai can understand each other languages. Though differences between the 2 languages do exist, 1 month is considered more than enough for a Lao or Thai to understand the spoken language of one another after first contact. Moreover, the language of people living in the North-Eastern part of Thailand, which are also those who work in factories and farms in Thailand, is generally considered Lao language.

(4) Finally, Lao government should continue its effort to find a solution for piracy problems in the motorcycle sector

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

Unlike its giant neighbors, Laos is not a country that foreign companies will have to rush in not wanting to miss the bus. In countries that domestic market is enormously huge like China, India or even Thailand and Vietnam, a sum of expected large income in the future may compensate existing problems. However, in a country of only less than 6 million people like Laos, much are needed to be done in order to off set disadvantage of small domestic market size. Creating environment where private companies can fairly compete is one among many others.

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5. Study Report on Lao Coffee

Kazuo SAMBONGI

Summary

This study looks at Lao coffee from an agricultural viewpoint.

Virtually unknown outside the country, Lao coffee and its cultivation techniques and motivation for production lag way behind those of other countries. Firstly, support is required in both hardware and software with the aim of improving quality and increasing yields. We have presented concrete measures to the Lao government for the support of the coffee industry (establishment of a Coffee Board, expansion of the Coffee Research and Experimentation Center, training in growing techniques for farmers, promotional activities, etc.), but all the problems require immediate action. It will take some time for Laos to establish an international position, but it must work towards this goal step by step.

5. Study Report on Lao Coffee

1. Introduction

Lao coffee is not yet a familiar name in Japan and most people have probably not even heard of it. A mere 50 bags (3,000kg) were imported into Japan in 2003 and between January and June 2004 no Lao coffee was imported at all. According to available information, "Canephora (commonly known as Robusta), Arabica and Liberica are grown in Laos, and Typica, called the origin of Arabica, is also found. Recently, a hybrid variety called Catimor has also started to be grown in large quantities."

Agricultural economic studies of the Lao coffee industry have been conducted, but no agricultural research studies. This study of the Lao coffee industry was conducted in a short time primarily from an agricultural viewpoint.

2. History of Lao Coffee

Coffee was introduced into Laos around 1930 by a Frenchman who introduced the Arabica and Typica varieties. After these were devastated by frost and coffee rust, Canephora was introduced in the 1980s, and around the same time the Caturra and Catuai variety of Arabica were introduced from Cuba. Then, between 1990 and 1994, Catimor was introduced as a means of countering coffee rust. Liberica was introduced in the 1950s. This information was put together without reliable verification despite interviews with a number of people involved in the coffee industry.

Social trends in the 1980s led to the Lao government encouraging coffee growing by the Lowland Lao on the Bolaven Plateau with the result that vast areas of forest were cut down by Nikhom, the coffee growers' association formed by new settlers and the government, to create coffee plantations. At this time, the Lao government was using coffee to repay the debt incurred by the purchase of weapons from socialist countries during the civil war. By forcing farmers to grow coffee, morale fell and the quality of coffee deteriorated. Upon joining ASEAN in the mid-1990s, the government reviewed its main export commodities other than timber and electricity and efforts were focused on coffee growing. At this time, with the participation of the private sector, large-scale plantations began to appear, but with the slump in the world market for coffee over the past few years, Lao coffee production has entered a difficult period.

3. Agricultural Information

(1) Coffee production, yield and export volume

Total coffee production in Laos in 2002 amounted to 32,197 tons from an area of 36,624 hectares with a yield of 0.88 ton/ha. Export data shows 14,748 tons in 1998 and 8,206 tons in 1999. The growing area is increasing every year, as is the production volume. However, according to "Les Cafés Produits Dans Le Monde" published in 1992, overall data for Laos shows 20,000 hectares under cultivation, production of 6,000 to 7,000 tons, exports of 5,000 tons, and yields of 0.2 ton/ha for arabica, 0.4 to 0.5 ton/ha for liberica and 0.35 ton/ha for robusta. It is thought that these figures were the result of catimor not having been introduced at the time. The yield is assumed to have increased after catimor began to be grown.

As for exports, nearly all coffee exported from Laos passes through Bangkok in Thailand with some being exported via Lao Bao in Vietnam, but this could not be confirmed. A route to Da Nang in Vietnam has also been established in the past few years. Export costs can be reduced by using the route to the port of Da Nang.

(2) Characteristics of coffee varieties grown

Various types of coffee are grown in Laos. Worldwide, only a few countries, such as Brazil, Indonesia, Vietnam and Cameroon, grow both Arabica and Canephora. Cultivation management and distribution are therefore complex.

***Coffea Arabica**

Typica, a variety of Arabica, was the first type of coffee to be introduced into Laos. Today it is grown in only a few countries, including Jamaica, Hawaii, Indonesia, Ethiopia and parts of Vietnam. It is extremely difficult to grow and requires a great deal of effort. It is regarded as the best type of coffee and is valued for its scarcity. There are very few Typica trees in Laos and it was not possible to find a plantation growing only Typica. We heard that it was grown in an area far from the main highways and inaccessible even by car, but as it was the rainy season and not harvest time, we were unable to go to the area. We would like to go there at harvest time and do a study.

Catimor was introduced in the 1990s. Strictly speaking, this is not an Arabica species, but we have included it as such. Catimor was produced by artificially crossing Timor Arabica, a natural cross between Typica and Canephora produced in Timor, and Caturra, a mutation of the Bourbon variety. The purposes of developing Catimor are: 1) it is easy to grow and the trees are short and grow quickly, 2) it is resistant to disease (coffee rust), and 3) it produces a high yield. However, attention must be paid to quality as it requires continuous fertilization and contains a strain of Canephora. This variety of coffee is popular with farmers because it is easy to grow, the trees grow quickly and are resistant to coffee rust, and yields are high, but without continuous fertilization, the trees become weak and die. We actually saw this phenomenon at a plantation we visited where the trees had not been fertilized. With regard to quality, there is currently no problem with Catimor from Vietnam and Indonesia, but there have been problems with Varieda Colombia from Colombia and Ruire 11 (a crossbreed like Catimor) from Kenya. In the case of Colombia, the All Japan Coffee Association went so far as to send a fact-finding mission.

At the present time, Catimor is popular in Laos and it is widely grown on both large and small plantations. Only Catimor is grown on large plantations, while on small plantations it is used for new planting and can be seen mixed with Canephora. As it has only been grown for three or four years, pruning is not a major concern yet, but the height of the trees must be kept within reach for harvesting. Fertilization is carried out on large plantations, but almost not at all on medium and small plantations. The effects of this are already evident in places, but it is to be hoped that it does not lead to major problems in a few years' time.

***Coffea Canephora**

Canephora is widely grown, but almost no cultivation management was evident on any of the farms. For example, almost no pruning was performed and awareness of pruning was low. However, when we asked agricultural instructors and farmers for their opinions, they knew about pruning and recognized its importance, but they were too preoccupied with immediate income to prune or cut back the trees. The cost of pruning shears and saws is not cheap for farmers, but these tools are indispensable from the viewpoint of future coffee yields.

***Coffea Liberica**

There were some plantations where Liberica was mixed with other coffee varieties, others where it was planted along the borders, and some small plantations where it was the sole variety. Its uses include domestic consumption with some exported to Thailand and Cambodia.

(3) Geographical Conditions

Coffee in Laos is grown almost exclusively on the Bolaven Plateau in the south of the country, covering the provinces of Champasak, Saravan, Sekong and Attapeu, with production concentrated particularly in the Pakson area of Champasak province. During our stay, a large sign written in Lao and English was put up in the middle of Pakson saying “Welcome to Pakson, home of famous Pakson coffee”. Bolaven Plateau has an altitude of between 500m and 1,200m and both its climate and soil conditions are said to be ideal for coffee growing. The plateau is shaped like an upside-down bowl and is flat on the top, making it ideal for growing agricultural produce.

Up to a height of 400m there are many farms growing tropical fruit such as durian, mangos and papaya. Beyond 500m Robusta is grown in many places and above 700m Catimor starts to be grown with arabica Typica grown above 1,000m.

The Coffee Research and Experimentation Center is situated at 900m on the edge of the bowl. Steep slopes drop away towards the gorge and there are many waterfalls.

(4) Climate Conditions

According to the climate data for the past six years, obtained from the Coffee Research and Experimentation Center at 900m, the average temperature is 22.4°C with a highest average temperature of 26.9°C and a lowest average temperature of 17.5°C. The highest temperature in this period is 33°C and the lowest 8°C. The actual temperature in the coffee growing area above 1,000m is presumed to be a few degrees lower. Frost seems to be rare. Recent frost damage occurred in 1999. Rainfall is 3452.4mm, adequate for coffee growing. The dry season lasts from November to May and the rainy season from June to October. Harvesting starts at the end of the rainy season.

(5) Soil Condition

At 30cm to 50cm, the topsoil is relatively thick and the soil is fertile red or black soil. The appropriate pH for coffee growing is said to be between 4.5 and 5.5, but when we measured the pH in various regions using a simple pH meter, the results were pH6.7 to pH7.0. It is likely that the acidity was higher at some time in the past and the soil came close to becoming neutral as a result of slash-and-burn farming before coffee started to be grown. The acidity does not need to be adjusted, but use of large quantities of organic fertilizer is recommended.

4. Cultivation Management

(1) Large-scale plantations

The only large-scale plantation is that owned by the DAOHEUANG TRADING Co., Ltd. Plantations in Laos are incredibly splendid. We were able to interview Mrs. Leuang Litdang, the owner of the company, and the plantation manager.

The plantation was founded in 1999 at an altitude of 1,110m and is situated approximately 20km east of Pakson. It covers a total area of 293 hectares with 250 hectares given over to coffee growing. It is infinitely more splendid and well kept than the smaller farms. The main variety of coffee grown here is Catimor and there are plans to grow other varieties too. The plantation manager and technical staff are Vietnamese and many of the workers are also Vietnamese. Coffee seedlings, shade-grown trees and fertilizer are all purchased from Vietnam. Catimor is resistant to coffee rust, it grows quickly and the trees are short and give a high yield, but without continuous fertilization growth will be compromised. This is well understood and the trees are fertilized annually with 1 ton of mixed fertilizer per hectare. The effects of lack of fertilizer, which were seen in other areas, were not evident here at all and the trees showed good growth. Unlike in other areas, the shade-grown coffee trees were also well pruned. There was a processing plant on the plantation that used the washing system. It had a pulping machine and fermentation tank capable of processing 16 tons of raw beans a day. Fermentation seemingly takes 8 hours. Everything was purchased from Vietnam.

Pakse has its own processing facilities and is equipped with equipment for processing its own coffee beans as well as Robusta purchased from small plantations. It has hulling machines capable of processing 40 tons of coffee beans an hour, and drying machines.

(2) Medium-sized plantations

Medium-sized coffee plantations are 5 hectares to 30 hectares in size. Robusta used to be the main variety grown, but as these plantations have more financial resources than small plantations, they are gradually switching to Catimor. However, it is not clear just how knowledgeable the farmers are of coffee growing and processing, and processing-related problems arise when the catimor trees have grown and are producing a good harvest. No fertilization was carried out at the plantation that we visited and wilting was evident.

(3) Small-scale plantations

Most coffee producers in Laos are small plantation owners. The growing area is between 0.5 hectares and 3 hectares. Robusta is the main crop, with some farmers planting a mixture of Typica and Catimor with Liberica along the borders. Coffee management varies from plantation to plantation, but most of the trees are in a very poor condition due to lack of pruning, fertilization or pest control. Nearly all are fertilizer-free and agricultural chemical-free, but this is not due to implementation of organic farming methods but to lack of funds. Some farms are pervaded by the coffee berry borer. At the very least, the beans that have fallen to the ground must be collected and burned at harvest time. In some areas shoots that had sprouted from the ground could be seen in large quantities.

5. Problems

(1) Cultivation management skills

Officials at the provincial agricultural agencies and the farmers have a certain level of knowledge about coffee growing, but that knowledge is not reflected in actual cultivation. Even with regard to pruning of canephora, very few places do any topping or cutting back. The trunks of coffee trees that had been cut back could be seen piled up in an orderly manner under the houses, but it appeared that the trees had been cut back more out of the need for fuel than out of care for the trees. However, while at the very least the new twigs growing out of the stump are removed, on most farms no topping work is done and the trees are left to grow at will. The height must be kept within reach in the range of 2m. Coffee trees that are left to grow at will be regenerated by cutting back. Farmers naturally do not want to do this as their immediate harvest will be reduced to zero. However, it is better done for the sake of future harvests.

In the case of catimor trees, they are usually topped at 1.6m to 1.8m and no pruning is done during the growing stage.

(2) Seedlings

We observed farmers raising seedlings, but the first thing we noticed was that the pots were too shallow. Production of seedling is an important process in the growing of coffee and unless the seedlings are healthy, they may suddenly die after a few years. If the pot is not deep enough, the main root grows to the bottom of the pot, then bends because it cannot grow straight and splits into a forked shape.

One of the most fatal diseases to strike coffee trees is rust. Historically, Typica growing in Laos was abandoned because of this disease, leading to the planting of Canephora and Catimor trees, but if Typica with its scarcity value is to be revived, measures must be taken to deal with coffee rust. Although we were unable to visit the typica-growing region because it was the rainy season, there are a number of measures that can be taken to deal with coffee rust. These include spraying with Copper fungicide, growing of healthy coffee trees and cultivation in well-ventilated locations, but the problem must be solved if Typica production is to be increased.

The most dangerous pest in the world for coffee trees is the coffee berry borer. Many were seen on this visit and the situation is very serious. Trees must be sprayed with Endosulfan, but the most effective method is field sanitation. Berries that have fallen to the ground after harvesting must be collected and burned. If they are left on the ground, the insects can hibernate and hatch the following year, causing great damage. Farmers are totally unaware of this. Unless the administration takes action, the Laos coffee industry may be badly affected. If farmers are unable to buy agricultural chemicals, then field sanitation is the best answer. Farmers must collect the coffee berries that fall off the trees and burn them.

(3) Processing

We visited the processing facilities on the Daoheuang plantation, but as they were not in operation, we were unable to check the work content. On the other plantations, they said that they sold the beans as cherries, but we wondered how collecting is carried out. As production increases in future, it will be necessary to build washing plants. Quality inevitably deteriorates if it takes a long time from harvesting to processing. Uniform quality cannot be guaranteed if each farmer washes his own beans in small quantities.

If no action is taken, quality will only deteriorate more. A study must be made of processing at harvest time. How do small farmers actually work? If production is to be increased in future, what kind of processing system is needed? One idea is to take the beans to the large-scale Daoheuang washing plant, but if production increases, this will be difficult due to problems of capacity and distance. Appropriate advice will be possible when the overall picture is a bit clearer.

(4) Quality control system

Laos does not yet have any quality standards or export standards. Exports are graded according to the standards of the buyer. This is not beneficial for Laos' development. First, Laos must establish export standards and prevent the export of poor quality products. This task should be promoted with the utmost urgency. The establishment of a Coffee Board has also been suggested, but it may be possible for the work of such a board to be performed by the present Coffee Export Association.

(5) Growing of Typica, valued for its scarcity

As mentioned earlier, Typica, a valuable variety of coffee, is grown in Laos. The growing area is situated deep in the interior of the country and is inaccessible by car. The current status of typica growing needs to be confirmed. The samples obtained from the Coffee Research and Experimentation Center vary widely and are thought to have been collected from a number of areas, but the beans roast well and have an excellent aroma. Production of Typica should definitely be increased. Naturally, cultivation will not be easy to manage and the yield is less than catimor, but the commercial value is extremely high. We would like to see Typica seedlings grown at the Coffee Research and Experimentation Center and distributed to farmers, and guidance provided in management methods.

6. Future Issues

On this visit we were able to briefly survey the coffee industry in Laos, but as described above, there are many problems. However, a great deal of effort must be put into the coffee industry and these problems must be solved. Unfortunately, this time we were unable to observe the harvesting or processing of the coffee beans. This will be important for checking the quality of the beans. We were also unable to visit the Typica growing area. Typica will occupy an important position in Laos' future coffee industry. Measures must be taken to improve farmers' cultivation techniques, a cultivation manual must be prepared for coffee growers, and studies must be conducted to eliminate the coffee berry borer, which is becoming an increasing problem.

7. Proposals to the Lao Government

The following proposals are made for the future development of the Lao coffee industry.

(1) Establishment of Coffee Board

Coffee workers (producers, processors, distributors, exporters, etc.) need an organization where all aspects of Lao coffee can be discussed. Such an organization will also need to publicly announce statistics relating to coffee (production volume, export volume, etc.).

A Coffee Export Association exists at present and this organization could be reinforced.

(2) Establishment of quality standards

It is no exaggeration to say that there are no quality standards at present. Standards must be established without delay. After basic quality standards have been established, they can be adjusted with the cooperation of export customers.

(3) Expansion of Coffee Research and Experimentation Center

Although the facilities in Pakson are good, there are only 14 research workers and not a great deal of research is carried out. If energy is going to be focused on the coffee industry in future, the research institute must be improved.

(4) Development of human resources

It is important to train specialists in coffee cultivation techniques, tasting, etc. Human resources must be developed for the Coffee Board, Coffee Research and Experimentation and Ministry of Agriculture.

(5) Improvement of cultivation management skills

This is the task of the Coffee Research Institute, but the following items are urgently needed.

*Cultivation methods for all coffee varieties (increased yields and improved quality)

*Cultivation guidance regarding catimor

*Cultivation guidance regarding typica

*Measures to deal with pests and disease (coffee rust, coffee berry borer, etc.)
*Guidance in harvesting and selection techniques

(6) Support for small growers

Software support in the area of cultivation management techniques is needed for small growers, and help is also required for hardware such as pulping machines, coffee seedlings, pruning shears and saws.

(7) Promotion

Lao coffee is virtually unknown outside the country. Efforts must be put into promotion of foreign exports and education for domestic consumption.

8. Conclusion

The international coffee market is presently in a slump due to increased production in Brazil and Vietnam. In addition, international competition is fierce and the producer nations are doing everything they can to survive. Improved quality is essential and coffee with scarcity value and distinctive features is popular. Lao coffee is virtually unknown and cannot be described as good quality. Compared with other countries, Laos does not have a long history of coffee growing and it has the disadvantage of being a landlocked country. In addition, the main varieties of coffee grown are Canephora and Catimor and, even if exported, the aim will simply be to increase the volume. Laos has no record of exporting to Japan, and with Vietnam, a major producer, next door, it will not be easy to establish a good track record. However, good quality type with scarcity value is grown in Laos and this presents a major opportunity. It may take a long time for Lao coffee to be recognized in Japan, but we hope that our activities will help to that end.

We would like to thank the following persons for their advice: Professor Yukio Ikemoto of Tokyo University Institute of Oriental Culture, who has studied the Lao coffee industry from an agricultural economic perspective, and Ms. Yoko Matsushima, a Post-graduate Course Student, Department of Agricultural and Resource Economics at Tokyo University.

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6. Coffee Economy in the Lao PDR:
A review of Development under the Changing Trade Environment and Export Potentials

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Summary

This report attempts to empirically analyze the coffee sector, which is one of important export commodities in 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 the coffee as an export commodity and obtain political implications. Our study found out that as a result of the various activities of newly participating private sector in 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 in the direction of improving the quality of Lao coffee. In Laos there are only a limited number of detailed researches on the production and market structure of any specific agricultural product for export, let alone coffee. Hence, this report is based upon the findings of the field survey carried out in relevant regions.

It was in the early 1900s under the French colonial regime that coffee production begun in the southern provinces of Laos. Until the mid-1990s when the Lao Government encouraged private companies to go into coffee business, Lao coffee had been produced by small-scale farmers, and local middle buyers, who were also coffee producers themselves, had bought coffee directly from these coffee farmers. However, changes have been taking place since private companies began to operate large-scale coffee plantations and introduce a new coffee variety, as well as to buy coffee from farmers as exporters. The first major change is observed in production techniques among farmers triggered by the introduction of a high-yield variety, Catimor. In comparison to the Robusta variety which is the main variety produced by local farmers, the Catimor variety requires the application of chemical fertilizer and is more labor-consuming in maintaining works such as pruning, weeding and planting shade trees. Furthermore, after the harvest, Robusta coffee cherries are usually directly dried in the sun and shelled, whereas Catimor coffee cherries is processed in a wet-dry method. When a wet-dry method is applied, cherries are soaked in water after pulps have been removed, and then dried with parchments still covering the coffee beans. Thus, compared to Robusta that demands less care, Catimor requires the input of capital and labor to a greater extent. As a result, small farmers are precautious to introduce Catimor.

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The second major change took place in the local trade system of coffee, including the ways of coffee purchased from farmers. Private companies that have launched on the coffee business mostly plant Catimor in their plantations, out of which one large-scale plantation is equipped with facilities for the wet-dry method. Such a large plantation uses modern facilities for the wet-dry processing not only coffee cherries from their own plantations but also freshly harvested coffee cherries purchased from farmers. Before private companies entered into the coffee business, Robusta had been traded as sun-dried cherries or green beans that had been shelled. Following the introduction of Catimor variety, Robusta is still traded the same, whereas Catimor has been traded as fresh fruits, beans with parchment after the wet-dry process, or green beans after dry-processing and hulling. In the past, local middle buyers used to buy coffee in the neighboring villages, and due to reasons such as transportation inconvenience, farmers had to accept the prices quoted by middle buyers or often tolerated their cheating in measurement. However, in recent years farmers increasingly prefer to sell their coffee directly to the warehouses owned by private companies. This has the advantage of avoiding problems in pricing and measurement, as well as getting the payment smoothly.

The coffee sector that had remained stagnant for a long period of time has come to a turning point in various aspects through the participation of private companies in the coffee business. In addition to various domestic factors in Laos, the international coffee prices fluctuate sharply according to the crop situation of major coffee producing countries. As Laos 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 high-quality and high-price. For that reason, in addition to the high quality, it will be essential to define the characteristic features of the Lao coffee to gain a brand reputation as good coffee. Coffee farmers in Laos has 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. Some of the features in this farming system have appealing points to coffee importers. Therefore, upon promoting 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, and also deepen the understanding of the needs of potential Lao coffee importers.

6. Coffee Economy in the Lao PDR:

A review of Development under the Changing Trade Environment and Export Potentials

I. Introduction

The Lao PDR (hereafter, Laos) is located in the heart of Indochina bounded by China, Vietnam, Cambodia, Thailand, and Myanmar. Laos is often characterized by its small and sparse population, of which 75 percent reside in rural areas. The leading sector in the economy is thus agriculture, of which the GDP share accounts for over 50 percent. In accordance with joining ASEAN, Laos is not exempted from opening the country's economy to the regional integrated economy. The ASEAN Free Trade Agreement (AFTA) requires member countries to reduce tariffs under the Common Effective Preferential Tariff (CEPT) scheme. The Lao government is committed to accomplishing a tariff reduction schedule by 2008. In addition to the institutional aspect, various region infrastructures, such as the construction of roads that will connect landlocked Laos to Da Nang port in Vietnam, are nearly completed. Laos is also a part of these dynamic transitions in the region, and its impact on the country's socioeconomic situation is expected to be large.

The Lao government is eager to alter the country's trade balance structure, which is consistently in excess of import over export. One of the important export commodities, coffee has been produced in the country for over 50 years, but it is only recently that Lao coffee has been exposed to the constantly changing world coffee market. Producers of Lao coffee, as well as of other agricultural commodities, have been mostly small farmers for a long time. The situation is changing, however, with large planter-exporters' involvement in both the production and export of coffee. Large planter-exporters are introducing new technology to produce high-quality coffee, and function as information providers on the world coffee market. The trade relationships between middle-buyers, exporters, and small farmers are also changing. Coffee is now becoming an important export commodity in Laos, and is expected to expand in the future. AFTA itself is considered to have little impact on coffee production in Laos, because major importers of Lao coffee are not ASEAN countries at the moment. As the coffee sector is undergoing changes, it is a good example to study in depth. A careful investigation of the current leading export commodity in the agricultural sector is certainly useful for understanding the future prospects of the Lao export sector as it enters into world market transactions.

This paper will first review the overall status of the Lao coffee sector, then look into each player of the sector and their interactions. Finally, based on these discussions, we will point out some constraints of exporting Lao coffee, as well as future prospects. The market of the Lao economy is considered to be underdeveloped, while detailed study of both the production and market structure of particular export commodities has been almost absent. The intention of this study is to examine the Lao coffee sector and derive some implications as to the possible direction or strategy suitable for Laos with an eye on integrating themselves into the world trade market. This study is based on field surveys undertaken to acquire firsthand information, a distinctive feature of the research.

In the next section, we review Laos's external trade, and coffee is presented as an important export commodity in the Lao economy. The third section will describe the current situation and the surrounding environment of Lao coffee. In section four, different coffee producers and their characteristics are observed. Section five will discuss some changes and issues arising from having an active connection with the market economy. Finally, the last two sections will consider perspectives of the Lao coffee sector and possible policy implications.

II. The Export Sector in Laos

Laos has been making efforts to transform its economy from a centrally-planned economy to a market-oriented economy since 1986, under the New Economic Mechanism (NEM) regime. Thereafter, international trade has been gradually liberalized and has come to play an important role in the country's economic development. The ratio of total external trade to GDP, which indicates the degree of openness or trade liberalization, has increased from 25 percent in 1992 to nearly 46 percent in 2002. Although the figure is improving, the performance is still modest compared to that of other neighboring ASEAN countries, such as 94 percent in Vietnam, 107 percent in Thailand, and 66 percent in Indonesia in 2000 (UNIDO/MIH, 2003).

The Lao export sector has gradually developed since the 1990's. Currently, Laos is exporting various commodities to over 50 countries. Among those, the main export destinations accounting for 80 to 90 percent of total export are the EU, ASEAN, Japan, the USA, and China. The EU market shares nearly 50 percent of total export in recent years. The second largest market is ASEAN countries. However, export to ASEAN member countries is still limited, even though the country joined ASEAN in 1997. For example, in 2000, while more than 80 percent of Lao export to ASEAN was concentrated on Thailand, less than 20 percent was towards the rest of members (Table 1). The table indicates no clear change in the composition of export destinations before and after joining ASEAN. At the moment, it is more important for Laos to maximize the benefits of receiving GSP (General System of Preferences) from 35 countries, including the EU, China, Australia, and New Zealand. One important GSP, which started with the EU in January 2002, grants a duty exemption to all Lao exported products except arms. Moreover, among those 50 Lao trade partners, 18 have signed bilateral trade agreement with Laos, which is expected to contribute to deeper and wider trade in the future.

Foreign currency earning from export has been improving every year except during the Asian crisis. On average, it accounts for 15 percent of the GDP during the period of 1992 to 2002. In this period, export growth has fluctuated in a wide range, from -10 percent to 80 percent. The average growth of export in this period is 11.4 percent, while that of import is 14.8 percent. In 2002/03, the export growth was 9.7 percent, which is 1 percent higher than its target plan, partly because of increased gold exporting. The export value is much less than the import value every year, resulting in a trade deficit problem. In 2002/03, the estimated export and import values are US$350.5 million and US$555.9 million respectively. Despite the fact that Laos has been facing a continuous trade account deficit, it is on average less than 10 percent of the GDP except for the years 1996 and 1997, in which it was 12.3 percent and 10.7 percent respectively.

The change in main export commodities in the last 10 years can be seen in Table 2. Wood and wood products as well as electricity are still the leading commodities, while the garment industry has increased its share under the GSP scheme. However, these export commodities are mostly primary products, and the value added remains minimal. Under the current trade structure, and taking the importance of agriculture into consideration, coffee seems to be a potential future export commodity.

The share of coffee export value varies every year and declined to 3 percent in 2001/2002. As a small coffee-exporting country, changes in the world coffee market in terms of quantity and prices directly affect the coffee business in Laos. For instance, Laos exported a large amount of coffee at good prices in 1995/96 because of a coffee shortage due to crop damage in Brazil. The main markets for Lao coffee are European countries, such as Poland, Belgium, Switzerland, Germany, and Spain. Apart from the EU market, Lao coffee is sold to many other countries, such as the USA, Japan, China, Taiwan, Australia, Norway, Thailand, and Singapore, but only in small amounts.

III. A Review of Coffee Sector Development

III-1. The world coffee market and Lao coffee

Coffee is the second largest trade commodity in the world after oil, and is thus the largest agricultural commodity traded. Although coffee production fluctuates every year, the global long-term trend is increasing (Figure 3). Like other agricultural commodities, coffee is also characterized by its volatile price fluctuations, which are often caused by crop damage in its largest producer, Brazil. After the last peak price in 1997 and relatively high prices during the period following, the price trend has consistently been downward, marking new lowest prices every year. The coffee market is flooded with excess supply from further production expansion in Brazil, as well as from Vietnam, a new and rapidly emerging producer. Vietnam expanded coffee production so rapidly that it has now become the second largest coffee producer in the world. The sharp increase in the production of Robusta coffee in Vietnam is often blamed as one of the reasons for the recent low international price (Figure 4).

Among the ASEAN countries, Vietnam and Indonesia are the prominent coffee producers (Table 4). Thailand is also increasing its coffee production and is now a member of the International Coffee Organization (ICO). ICO was established to control quantities exported from producers in an attempt to stabilize fluctuating prices. Therefore, ICO requires a minimum quantity to be produced for a country to qualify as a member, which Laos cannot meet. Compared to the ASEAN countries mentioned above, Laos is a small producer. The disadvantage of being a small producer is that the country has virtually no influence on price. The price of Lao coffee is determined by referring to the international market price, thus the Lao coffee sector is always facing the risk of price fluctuations. Another constraint of Lao coffee is the country's geographical disadvantage: Laos is a landlocked country with no port. At the moment, almost all coffee exported from Laos must go by way of Bangkok, Thailand. As a result, the transportation cost falls heavy on products exported from Laos. There are expectations that upon the completion of the East-West Corridor, Laos will have another option to export from a port in Vietnam, which will bring Laos negotiation power for reducing transportation costs.

III-2. A brief history of Lao coffee

It was the colonial French who first introduced coffee planting to Laos in the early 1900's. Before starting substantial production, the French tested growing coffee in different areas of the country. The Boloven Plateau in the south was found to have a suitable ecology and environment for coffee production. At the time, coffee beans produced in Laos were mostly exported to Saigon, Vietnam. After the French reign, the coffee sector did not see much development. Farmers kept coffee trees for the time being, but trees were left without proper maintenance.

There were two important periods in the history of Lao coffee. The first was in the 1980's when the Lao government encouraged lowland farmers to move to the Boloven Plateau to start coffee production. A vast area of forests was cleared and developed by the new immigrants, as well as by members of the government-organized cooperative called 'Nikhom'. Nikhom was a group of people with different occupations and residency backgrounds, but mainly consisting of military soldiers. It was a measure to provide employment opportunities for soldiers after the war. At the same time, farmers' cooperatives called 'Sahakone' were established. According to interviews of village leaders in the Pakxong district, Sahakone were encouraged by the government but not necessarily mandatory. In the Pakxong district, most of the Sahakone only functioned as agents to collect crops and distribute coupons and goods in return. These Sahakone in coffee-producing areas did not collectively work in the fields, unlike in the lowland rice paddy regions. Also, many of the Sahakone in Pakxong did not last for more than three years. Many Sahakone failed in the area because villagers were dissatisfied with the distribution of goods[1] and with the price offered for their crop. In fact, disgruntled farmers tried to smuggle coffee into neighboring countries, despite the fact that punishment awaited them.

Coffee produced during this period had a special purpose: it was used as a form of repayment to other socialist countries for debts accrued during the revolutionary war. The coffee price was negotiated between the two countries and did not reflect the market price. Quality was neglected while quantity became an important aspect of the country's coffee production. Harvested coffee was procured at a set price by the state-owned company representing the government. Collected coffee was mainly exported to former socialist countries such as the former Soviet Union and Vietnam, mostly in kind. What was required for coffee production then was quantity, not quality. It is easy to imagine that farmers did not have much incentive to improve their coffee fields, and it was during this time that the quality of Lao coffee is thought to have declined substantially. Many villagers recall that it was around this time when they could no longer dry their coffee beans in a quality way[2] because of the rapid increase in production.

The second important period was the mid-1990's, when the Lao government was seeking an attractive export commodity in accordance with joining ASEAN. In those days, wood and timber was literally the only significant export commodity in the country. It is not by chance that at the time of the government's decision, the price of coffee was reaching its highest peak in a decade. The government encouraged large

[1]Due to a limited goods supply, goods were distributed evenly among villagers regardless of a farmer's diligence.
[2]As will be described later, in the past, farmers dried coffee beans using the wash-dry method. Farmers began using the easier direct-dry method to meet the production increase.

private investors to engage in coffee trading and to develop coffee plantations in the Boloven Plateau[3]. Until then, most of the coffee fields were owned by local small-scale farmers, ranging perhaps from less than one hectare to two or three hectares at the most. As private investors developed large coffee plantations anew, the original small-scale farmers were also inspired and gradually expanded their production. It is only in the past ten years that coffee has really become one of the leading export goods in Laos (Table 6). The main export destination now is European countries as already mentioned, but the exports to these European countries have begun only since the mid-1990's. In addition, there are some exports to neighboring Asian countries, perhaps for further re-exports.

Figure 5 shows the country's production and harvested areas from 1961 to 2003. Both production and area harvested have been stagnant for more than thirty years, since the early 1960's. While the harvested area began to increase around 1985, the increase in production was subtle until a rapid increase was observed in the late 1990's. This is considered to be due to stagnant productivity during the time of debt repayment. The productivity or coffee yield began improving soon after the private sector started to play an active role. The recent low international coffee price (Figure 4) is affecting Lao coffee business as well. Some exporters carried over their stock for nearly two years[4] due to losses expected if they had sold at the price current at the time.

III-3. Coffee varieties produced in Laos

There are three main species of coffee[5] cultivated in the world, namely Arabica (*Coffea arabica*), Canephora (*Coffea robusta*), and Liberica (*Coffea liberica*)[6]. Of these three, Arabica (with an approximately 70 percent share) and Robusta are the main trade products. Arabica is high-quality coffee suitable for drinking as unprocessed regular coffee, and thus is traded at higher prices than Robusta. In terms of production, it is vulnerable to leaf rust disease and requires a higher altitude and better care, such as planting with shade trees, pruning, weeding, and fertilizer application. Robusta, on the other hand, is usually of low quality or inferior in taste, hence it is processed as instant coffee[7], canned coffee, or is blended with Arabica coffee. As the name indicates, Robusta is disease resistant, can be produced at lower altitudes, and is easier to maintain. It is important to distinguish the two as they are traded at different prices (Figure 4).

Of the three varieties, Arabica Typica was the first planted in Laos, but was damaged severely by frost and rust disease soon after its introduction. Then Robusta became the dominant variety in the Boloven Plateau. It accounts for more than 90 percent of all production in the country (Table 7). Liberica is also resistant to rust disease and can be grown at lower altitudes, but is said to have a distinctive strong flavor, thus the total quantity produced in the world is extremely small. Liberica is exclusively exported to a few

[3]The government provided investors land with preferential rental terms.
[4]According to a 2002 interview. The situation is expected to be different this year (2004).
[5]Robusta is a variety of Canephora. Although Arabica is a species and Robusta is a variety, these two names are the most often heard. For convenience, in this paper they are all referred to as varieties.
[6]Liberica is sometimes also referred to as Excella.
[7]Another reason Robusta is preferred for processed coffee is its water-soluble characteristics.

countries such as Cambodia and Oman where its unique flavor is preferred. In addition to these three kinds of coffee, a variety called Catimor is also important. Catimor is a hybrid between Arabica and Robusta, with a higher proportion of Arabica yet with the disease-resistant traits of Robusta. Catimor is a high-input high-yield variety and is traded at a higher price than Robusta, thus is encouraged in many countries, including Laos. Concerned authorities encourage new coffee plantations as well as existing small farmers at higher altitudes to grow Catimor. In order to emphasize that Catimor is also Arabica, both officials and individuals engaged in the Lao coffee business usually do not prefer to specifically distinguish Catimor from Arabica, but usually refer to both as Arabica. However, Catimor is traded at a lower price than Arabica Typica; moreover, a recent oversupply of low-quality Catimor from Vietnam has lowered the hybrid's international reputation. To seek a market for increasing Catimor is now one of the urgent issues faced by the Lao coffee sector.

III-4. Domestic Consumption

Domestic consumption of coffee in Laos is still limited. Although there are no supporting figures as there are in many other coffee-producing countries, Lao people, except those in large cities, do not drink coffee very often. Many coffee farmers rarely drink coffee, as they believe it will cause them health problems such as headaches and an elevated heart rate[8]. For farmers, coffee is a drink served on special occasions such as weddings and funerals. Women tend to avoid coffee more, both in rural and urban areas. In large cities such as Vientiane, the capital, are various coffee shops serving coffee in both the Western style and the local style. In rural areas, most large towns have small local coffee shops, but in some areas, it is difficult to find Lao coffee and only imported soluble coffee is available.

Local-style coffee is made with cotton filters and served with plenty of condensed milk. The coffee these local shops use is usually Robusta coffee, roasted rather strongly. Foreigners may find Lao local coffee to be strong or thick. This is partly due to the strong roast and the way it is served, but there is another reason. Lao coffee roasted for local consumption contains various additives included during the roasting process. Most commonly added are sugar, alcohol, and margarine. Sugar is added to increase its weight, while the other two are added for flavor. Other additives include tamarinds, roasted rice, soybeans, betel nuts, monosodium glutamate, lard, and salt. Some are added for weight increase, and some are added for flavor. Although domestic consumption is limited in many coffee-producing countries, there are also exceptions. The largest coffee producer, Brazil, has now become the second largest coffee-consuming country in the world. Encouraging domestic consumption, especially by making good-quality coffee available for local people and visitors from abroad, is an important market-expanding strategy. It is a pity that coffee-producing Lao people are often serving imported instant soluble coffee.

[8] In fact, many farmers we have interviewed, especially in the northern region, did not know how to process and serve coffee.

III-5. Production area

Boloven Plateau

The Boloven Plateau is located in southern Laos, extending to four southern provinces: Champasak, Saravan, Sekong, and Attapeu. In this large area, coffee production is concentrated in the Pakxong district of Champasak Province. Other coffee-producing areas in the region are the Lao Ngam district in Saravan Province and the Tha Teng district in Sekong Province (Table 5). Coffee production requires a high altitude, moderate temperature, soil with good drainage, and sufficient moisture. The Boloven Plateau meets these conditions, thus Lao coffee came to be known as Boloven coffee. The altitude in the plateau is high enough for coffee production, from 500 to 1200 meters. The average temperature is 25°C, and the lowest temperature is around 8°C. The soil in this region is covered by volcanic poriferous soil, and the annual rainfall is over 2,000 mm. Although there is sufficient rainfall in most areas, water is sometimes a serious constraint at altitudes below 800m. Pakxong is located 50 km from Pakse, the capital city of Champasak Province, and another 50 km from the Thai border. Given this location, coffee from the Boloven Plateau is mostly exported via Chong Mek, Bangkok, and further to other countries.

Inhabitants of the region are principally Lao Tueng people (meaning *inhabitants of the hill*), consisting of various ethnic groups of the Mon-Khmer subgroup, led largely by ethnic Laven people. Many of the residents in the region lived here for more than three generations at least, but not a small number of people migrated from Saravan, Attapeu, and other southern provinces during the 1960’s to early 1970’s in the chaos of the war[9]. These ethnic people are the primary coffee growers in the Boloven Plateau. Before the 1990’s, it is assumed that people in the region made their livelihood by cultivating upland rice, various upland crops, fruit trees, raising livestock animals, and other supplementary cash crops such as cardamom. Since the introduction of coffee, the upland rice fields have gradually been taken over by coffee fields. Farmers are now more dependent on a cash income, as many need to purchase rice from the market. There are also Lao Luem (*lowland inhabitant*) people who moved from the lowlands to grow coffee and other cash crops, and some Vietnamese and Chinese families who immigrated during the French era.

Within the region, people’s livelihood and agricultural activities differ according to the geographical condition, mainly determined by the altitude. Starting from Pakse to Pakxong, at the foot of the plateau, there are people who migrated from other parts of southern provinces. In these villages, rice paddies are not enough for self-consumption. Some villages burn waste-wood into charcoal while others engage in blacksmithing, selling tools such as sickles to earn cash income. This is seen at altitudes under 150 meters. Higher up, at altitudes between 200 and 400 meters, are many fruit trees, including banana, durian, papaya, pineapple, mango, soursop, and so on. Both Robusta and Liberica trees are planted here, but they do not bear coffee cherries[10] well. The first substantial Robusta and Liberica coffee fields appear at around 500 meters. From here upward, most households plant some coffee trees. Arabica and Catimor

[9]The Boloven Plateau is one of the areas severely bombed by Americans. Many bomb craters as well as unexploded bombs are found in coffee fields.

[10]The fruits of the coffee tree are called *cherries* after their size and color. After being dried and shelled, they are called *coffee beans* or *green beans*.

cannot be observed until the altitude reaches higher than 700 meters Near the coffee experimentation station located at 900 meters, many farmers harvest from old Robusta trees and have also been trying new Catimor trees in the past few years, as Catimor is strongly recommended. The oldest and now most valuable Arabica Typica is left in only a small amount, which can be seen at around 1000 meters and above.

Northern Provinces

In this paper, our study focuses on the Pakxong district in the Boloven Plateau region; however, there are provinces in the north where coffee are produced as well (Table 10 and 11). Little is known about the coffee in the north, but we assumed that there are two kinds of coffee in the north. One is the old and half-abandoned Arabica Typica brought during the French reign, the other is the new Catimor coffee introduced by various projects for an alternative crop to shifting cultivation and opium cultivation. In order to obtain information on what happens to the coffee produced in the northern provinces and to compare the situation with the Boloven Plateau region, we have conducted a survey in two provinces, Luangprabang and Phongsaly.

Luangprabang

In Luangprabang Province, the survey took place in six districts (Luangprabang, Nambak, Chongphet, Ngoy, Pakseng, and Phonesay). Many villages are undergoing restructuring or merging into larger administrative villages consisting of different ethnic groups. The people's livelihood in Luangprabang largely depends on upland crops. The most important is upland rice, followed by other cash crops such as Job's tears, maize, cassava, and sesame. At the moment, sesame and Job's tears seem to have a good price and are planted widely. These cash crops are usually collected by middle traders who represent companies from Thailand or China. Both Job's tears and sesame will be collected and exported to Thailand for processing. As for coffee production in Luangprabang, it is low and on the decline (Table 1 and 2). There are mainly two varieties found in Luangprabang, namely Arabica Typica and Catimor. Arabica Typica is assumed to have been brought during the French colonial era, while Catimor was introduced to a few villages via recent projects just a few years ago. There were also times in the late 1980's when the provincial government promoted planting coffee. Although not actively grown, coffee trees were kept by farmers and escaped extermination.

Coffee in Luangprabang used to be collected by local coffee shops[11]. There were quite a few coffee shops in town where they roasted and served coffee. Since the mid-1990's, many of these coffee shops have closed down, and now there is only one place in Luangprabang where we can taste Luangprabang coffee. Vietnamese soldiers had also bought coffee from farmers, and of course farmers also sold to governmental collection agencies. However, seeing no one to collect their coffee crops, farmers began cutting down their coffee trees over the past decade.

Coffee trees (old Arabica Typica trees) in Luangprabang in many villages are kept near the riverside

[11]Many of these shops were Vietnamese- and Chinese-owned.

with shade trees such as mango, tamarind, orange, and other natural trees. The number of coffee trees in villages is extremely small, with sometimes only two or three trees remaining. Most trees are left without any maintenance such as pruning, renewing, or weeding. Many have not even been explicitly planted, but rather developed into trees from fallen coffee fruits. In most villages we visited, Arabica Typica had leaf rust disease, but the farmers mentioned that coffee is very easy to care for and that coffee trees seldom die. The post-harvest processing in Luangprabang is similar to the wet-dry method. After the harvest, they will take off the fruits and skin either by squeezing by hand or by pounding them in cooking utensils. Then they will wash the beans in water to remove the slimy substance. Finally, the beans will be dried in the sun. The usual wet-dry method will have one more step of soaking in water for several hours or overnight before washing the coffee beans. Because many farmers pick the fruits by hand, they prefer to harvest only the ripe fruits. This is in contrast to Pakxong, where if they are not questioned about quality, farmers tend to harvest both ripe and unripe fruits together.

As in Pakxong, not many villagers in Luangprabang like to drink coffee. If they do, they will roast it themselves, sometimes adding alcohol, sugar, or roasted rice. In Luangprabang also, coffee is a drink for the elderly and perhaps monks in the village. Other than drinking as coffee, children enjoy eating the fruits, and young leaves are eaten with meat dishes. Coffee trees that remain without being cut down are mainly for these self-consumption purposes.

<u>Phongsaly</u>

Phongsaly is located at the northern tip of Laos, sharing borders with China and Vietnam of around 300 km each. Therefore, the agricultural production in Phongsaly is influenced much by trade activities in these two countries near the border. At the moment, important agricultural products in the province are tea, galanga fruits, sugarcane, cardamom, and so on. In the mountainous areas, people harvest upland rice and the various cash crops mentioned above. In areas with developed paddies, people rely on paddy field rice for their living. Unlike in Luangprabang, the history of how coffee was first introduced to Phongsaly cannot be clarified. This is probably due to the fact that coffee was never of any importance to Phongsaly farmers. In most villages we have visited, we have observed old Arabica Typica trees. Villagers do not remember when and how coffee came to the village, but they are sure that it has been growing there for some time—more than thirty years. In some areas, there are also trees of the Catimor variety introduced by foreign projects and a private company. There were problems associated with the introduction of Catimor, which will be discussed later.

There is one tea processing factory owned by a Chinese company in Phongsaly. The company has been promoting tea garden development on upland hillside areas. The local government supports these promotion activities as tea can be one of the alternatives to shifting cultivation. The local government allocated land for tea in each promoted village and assigned farmers certain areas or a certain number of tea trees for which they would be responsible. The factory will collect fresh tea leaves from farmers twice a week. The company sets different prices for different types of leaves[12], but in reality, only the cheapest

[12]Newly sprouted buds are 15,000 kip/kg, one bud and one leaf is 8,000 kip/kg, and one bud and two leaves is 1,4000 kip/kg.

type is collected. Both the company and farmers keep a transaction record book. The Chinese manager will record the amount collected and the amount paid to each farmer in the book. The factory will process the fresh tea and send it to China by 10-ton truck every month. For many farmers, tea is becoming the important and only source of income after having given up upland rice.

Another crop which has been operating in a somewhat similar way is sugarcane. Sugarcane is purchased by Chinese company and sent to China for processing. The local government also promoted sugarcane as a part of its immigration policy to encourage people living in the upland area to stop shifting cultivation and move to the lowlands. The local authorities have allocated land to these people for the cultivation of sugarcane. Farmers who grow sugarcane for this Chinese company have identification cards with basic information such as the name of their village and the name of the head of their household. During the harvest season, the labor is often short. The company, the local government, and the village leader will discuss the harvest schedule of harvest and keep records. Villagers will discuss further about the harvest schedule so they can exchange labor.

Coffee in Phongsaly has never been consumed locally. It was never an important cash crop, as there were no traders to collect coffee. Farmers who have sold coffee in the past usually sold to government cooperative shops, but they recall that they were able to do so only until the early 1970's. In villages near the Chinese border, farmers often visit relatives living in Chinese villages. These farmers used to take coffee to the Chinese border in small amounts (less than 10 kg) and sell it to Chinese middle buyers. It has not been a regular trade, and it has been diminishing rapidly in recent years. Coffee trees in Phongsaly are remaining old Arabica Typica trees with leaf rust disease, plus Catimor trees recently introduced through different projects.

One of these projects has been implemented as a part of a health and self-sufficiency project in the Boune Neua and Boune Tai districts. Coffee seeds were brought from Pakxong, and an expert was invited from that district to train villagers. At the beginning of the project, the extension officer from the district office came on a monthly basis to monitor the coffee's condition. However, once the coffee was ready to be harvested, they stopped visiting. The project did not seek a market for coffee and most farmers who planted the crop could not sell their coffee, not even once. Some farmers still take good care of their coffee trees, but if they cannot find a market in the near future, they would not hesitate to cut them all down.

There was one local man who tried to develop more than 9 hectares of coffee plantation in the Phongsaly district, bringing seeds from Pakxong in 1991. His plan was also supported by the provincial authority. He hired villagers to clear the land and plant coffee. At first, until the trees reached 50 to 60 cm in height, the plantation was in good condition. Thereafter, however, almost all trees died. Some villagers suspect an inappropriate fertilizer application[13]. The plantation operated for four years and closed down.

Another project was implemented by a private trader who was supported by a contract between the Vietnamese government and the Phongsaly provincial office. The contract was made in 1999 and the

[13]When we visited what remained of the plantation, coffee trees were planted close to each other (about 1 m apart), and no shade trees were planted.

actual planting took place in 2001. The trader brought a Catimor nursery from Vietnam and distributed it to villages in the Khua and Mai districts. Farmers were given simple planting instructions, such as to dig a hole 40 cm by 40 cm and apply fertilizer prior to transplanting the young plants. Even though coffee trees were planted in different villages with different geographies and soil conditions, in almost all villages the coffee trees have died. We observed the remaining coffee gardens and found that the surviving trees are also in poor condition. Their height is extremely short considering the age of the tree. Once the trees reached their harvest year, the trader claimed the amount produced was too small for him to collect from farmers and sell.

III-6. Administrative organization

To encourage coffee export and production, the government established the Coffee Exporters' Association Laos and restructured the experimentation station into the Coffee Research and Experimentation Center in 1995. The role of the former is to strengthen the export system and to seek new overseas markets. At the time of export, exporters must arrange official documents such as a certificate of quality, certificate of sanitation, and certificate of origin. These documents are issued only after exporters have reported to the Association, who will then issue the letter addressed to the authorities concerned. The intention of this system is to keep track of exported coffee. The latter was established in an attempt to experiment with and promote the higher-yielding and disease-resistant Catimor hybrid variety[14]. In fact, many farmers now buy seedlings from the institute, particularly the Catimor variety[15], and have also adopted better pre- and post-harvesting techniques as introduced by the institute. The predecessor of the experimentation center tested other upland crops, including tea. The government's intention of restructuring the center was to focus more on coffee and to promote the high-yielding Catimor variety. However, the center is obliged to experiment with other cash crops, such as various vegetables and fruits, in order to provide local farmers with alternative crops when coffee prices are low. Both organizations are located near production areas, thus the coffee sector is somewhat independent of the central government.

III-7. Export procedures

To export coffee to foreign countries, exporters have to complete several procedural steps. Those procedures can be divided into two main parts: the procedure before transporting coffee to the border checkpoint and the procedure at the checkpoint before the shipment. The minimum time needed to complete the entire process is about four days. After receiving an invoice from its foreign trade partners, a company or exporter can bring the invoice to the provincial Agriculture and Forestry Office to apply for the *Phito Salitare (*disease- and insect-free certificate) and to the provincial Technology and Environmental Office to obtain the *Quality Control* certificate. At the former office, the coffee product

[14]The restructuring of the center was supported by the French project Développement Rural du Plateau des Bolovens, Agence Française de Développement.

[15]Recently, other provinces such as Phongsaly, Oudomxay, Luang Prabang, and Attapeu purchased Catimor seeds from the institute to experiment with coffee production in the province.

will be examined for diseases, while at the latter office the product will be tested for moisture level, proportion of bad beans, and so on to see if it can meet the required trade partner standards. It takes roughly about one day to obtain the two documents. Exporters must pay the fee for each office at 500 kip/ton for products weighing under 100 tons or 1000 kip/ton for those weighing over 100 tons.

The next step, for the *General System of Preference (GSP)* certificate at the Provincial Office of Commerce, is to fill out an application form, attaching the two documents above. This certificate provides information about the product's country of origin. This also takes at least half a day or one full day to complete. Exporters will submit the three documents to the Finance Office to pay for the transportation tax, based on the cost of transportation from the warehouse to the border (60 kip/kg), and the profit tax (450 kip/kg). After all of the above documents are completed, exporters will apply for a customs certificate from the provincial Customs Office before transporting coffee to the border. Additionally, exporters have to inform the coffee export association about their export transaction and pay another fee (4 kip/kg). The aim is to provide the association with statistics on the volume of coffee exported.

At the border checkpoint, the product is measured by officials from the Communication Post Transportation and Construction Office. There, exporters will present all related documents mentioned above to the representative officials from the offices concerned before loading the product into the containers. At this point, exporters must spend about one day finishing all procedures. Currently, there are two routes of shipping: through the international checkpoint (Vangtao) in Champasack to a Thai sea port (Krongteu-Bangkok or Lemshabang-Pattaya) or through the international checkpoint (Dansavanh) in Savannakhet to a Vietnamese seaport (Ho chi minh-Vietnam). The Danang seaport is considered a small port, so receiving large ships is impossible. While Lao coffee is mostly exported to Europe by large ships, when it comes to shipping goods via Vietnam, exporters must transport their goods to Ho Chi Minh City and use the sea port there. The former route is 600 km and costs is $40/ton, while the latter is 1500 km and costs $70/ton. The decision of which route to travel is made by the foreign trade partners. Under the socioeconomic development master plan for the Cambodia–Laos–Vietnam development triangle, many national routes in that area are in the development stage, including national route number 18B. This provides an accessible way from Champasack (the coffee planting base) to Vietnam through Attapeu Province and is much shorter than previous routes. The road is now under construction and it is expected to be open for transport in 2005. It is believed that this route will be an alternative choice for coffee exporters to transport their products to Ho Chi Minh port in the near future.

Coffee exporters are facing several difficulties with the implementation of trade procedures, the main problem being comprehensive documentation procedures that take a great deal of time to complete. At the Vantao border checkpoint, even though a one-stop service unit has been set up for years, it does not function well in practice. Officials who are responsible for checking documents before shipping and officials who check products are working in different locations. Sometimes they are not present at their post during office hours or by the time exporters arrive. Even worse, when officials responsible for checking documents are absent for any reason and there is no other staff to stand in for them, the process will be delayed. When this happens, exporters must pay a fine to the shipping company that brings containers to the checkpoint for loading. Also, when products fail to reach the port on time, exporters must pay for the storage facility until the containers can be loaded. Moreover, the transportation services on the Lao side are still unreliable. Some trucks are too old, and mechanical problems may occur during the journey. While Thai shipping companies can bring their containers and wait for loading at the checkpoint, some Vietnamese shipping companies, starting this year, can bring containers to the exporter's warehouse for products to be loaded on the spot. The latter choice is preferred by exporters as it reduces the risk of product damage during the journey. In reality, however, Thai shipping companies are preferable to Vietnamese when one considers transportation costs.

IV. Lao Coffee Producers

IV-1. Small-scale producers

Small-scale producers make up the majority of coffee producers in Laos. Farmers often hold coffee fields in several different locations, from as small as a half hectare to 2 or 3 hectares. These farmers are the primary coffee producers in the region. Their grandparents' or parents' generation continued coffee production even after the French left the country. Therefore, most of these small-scale farmers learned coffee cultivation and inherited coffee trees from their parents. Although many farmers highly rely on market to purchase food, some still cultivate upland rice for self-consumption, as well as supplement their income by growing various vegetables, fruits, and tea, raising livestock, or by dealing with various non-timber forest products.

Small farmers mainly grow Robusta and a few Liberica trees. Most of these Robusta and Liberica trees are old, the farmers having inherited them from their parents. Small-scale farmers are often reluctant to introduce the new Catimor, although they know that Catimor can be sold at a higher price. Catimor requires a high initial investment[16] and high fertilizer application, as well as good daily maintenance of trees. It is difficult for small farmers to make such an investment and input in their coffee fields. Other often-mentioned reasons are that Robusta is more cold-resistant and easier to take care of, and that Robusta trees bear coffee cherries for longer periods than do Catimor trees[17].

Labor is a critical constraint, not only for small-scale farmers, but also for all coffee producers in the region. During the French reign, farmers produced a small amount of good-quality coffee and sold it at a higher price relative to other commodities such as rice. Nowadays, because of low coffee prices and further dependence on the market for purchasing food and necessities, it is inevitable that even small-farmers will produce a larger quantity. Family labor is often not enough to produce a large amount of coffee. Farmers tend to work in a labor-saving manner; they often mix harvest-ready ripe red fruits and young green fruits together to save their labor. Small-scale farmers' coffee fields are almost always left without proper pruning, renewing, and weeding, due in part to lack of labor. Occasionally, they hire laborers from the lowlands or from within the village for harvesting and weeding. The cost of hiring these laborers will put even more pressure on these small farmers to produce more. Besides insufficient labor, a

[16]For Catimor, it is recommended that 5000 trees per hectare should be planted, whereas it is around 3,300 trees for Robusta.
[17]Authorities have told farmers that the Catimor yield will decline sharply after 7 years.

lack of technical knowledge and unfamiliarity with the quality-price relationship are considered other reasons for inadequate labor input. When farmers are asked why they do not prune or renew coffee trees, they often reply that they want to collect as many coffee cherries as possible, that they are afraid to lose any coffee fruits. This suggests that they may not have information about the possible increased yield with proper pruning and the possible increase in unit price with improved quality. Another example is the post-harvest processing. Many small farmers dry directly on the ground or on plastic sheets instead of drying on a shelf[18]. It causes dirt to be mixed in and invites mold to grow on the coffee cherries. As a result of these problems, coffee produced by small-scale farmers generally gives low productivity and low quality, thus its low purchase price.

IV-2. Medium-scale producers

Medium-scale producers manage coffee fields ranging from 5 hectares up to sometimes 20 or 30 hectares. Two types of middle-scale farmers exist. One is the former small-scale farmer who gradually expanded their farming area and production. The other is the farmer who is not originally from the region but moved there from the lowlands—for example, from Pakse—to start growing coffee. At the very beginning of coffee production in Laos, these people who moved from the lowlands were the coffee producers. During the French reign, various requirements had to be met in order to start coffee production, such as the availability of capital for the initial investment and working capital, before farmers were given permission to plant coffee. Consequently, relatively wealthy merchants or traders were the first to start coffee fields in the area. Many middle-scale producers thus never cultivated rice, but earned their living by selling coffee and other cash crops such as black pepper, fruits, vegetables and various potatoes, buying rice in the market. At the same time, many of them engage in middle trading. They collect coffee from villagers or outside their own village and send to even larger middle buyers or to export companies.

As coffee producers, they are keen to adopt new techniques, but their efforts are still progressing. Many medium producers own old coffee fields with Robusta and Liberica trees. Catimor is planted on newly expanded land, and many of them are planning eventually to convert their old fields to growing Catimor as well. They actively adapt new techniques, such as wet-dry processing and the use of chemical fertilizer. However, it seems that the significance of quality is only halfway understood. In one of these farms, shelves were used to dry coffee as instructed. Yet when the coffee became wet from rain, the farmer dried it over the smoke from the fire. This may cause some serious problems in the coffee's quality.

As middle buyers, they have several roles. They are agents of export companies in the village. They receive orders from exporting companies, and intermediate between small-scale farmers and exporting companies. Transportation is also their important role. Middle buyers will provide transportation to send

[18]There are two ways to go about post-harvest processing. The dry method is to dry coffee cherries in the sun. After fermentation, the skin, pulp, and thin silver skin coating the bean come off easily with a huller machine. The dry method is applied for almost all Robusta beans and is predominant in Laos. Another is the wet dry method. The pulp is removed with a pulper machine soon after the harvest. At this moment, there is a slimy substance coating the coffee bean. In order to remove the slime easily, beans are soaked in a water tank and fermented for one night (the soaking time differs by environment). After the slime is washed off, coffee beans are dried on shelves under the sun. Coffee beans dried by the wet-dry method are still covered with parchment, and have better quality and are traded for higher prices compared to those dried by the dry method.

coffee from small farmers to exporting companies. They also often engage in a financial transaction with farmer called 'green coffee (*café kiao*) [19]', a form of loan which farmers pledge not-yet harvested green coffee in advance. They also rent out pulping and huller machines to small farmers. These middle buyers have been playing an important role to connect small-scale farmers with the outside market. As mentioned later however, there is a severe competition among middle buyers as large export companies started to collect coffee directly from farmers.

IV-3. Large-scale producers

Large-scale producers are the newcomers in the Lao coffee sector. They are owners of coffee plantation that can measure over 100 hectares. They are also exporters, and some of them are officers of the Coffee Exporters' Association. As Association officers, they have opportunities to meet foreign buyers or coffee experts who visit Laos, as well as to visit possible import countries for marketing activities. These opportunities, not available to other producers, are certainly exploited for their own business. Coffee produced in these plantations contributed much to the production increase seen in the country since the late 1990's. These exporter-planters are the leaders in the Lao coffee business, both in the private and public sectors. Through their marketing activities, they have learned that quality is a key factor for export. Hence, the most distinct characteristic of large-scale coffee producers came to be their emphasis on quality. The high-yield, higher-priced Catimor variety alone is planted in almost all plantations. Planters hire farmers to work on the plantation site to maintain coffee trees regularly and keep them in good condition. As a result of adequate pruning, weeding, harvesting, and post-harvest processing, both the yield[20] and quality of coffee produced in plantations are generally better than that produced by small or medium farmers.

The largest exporter-planter in the country hires coffee experts from Vietnam, has imported huller and drying machines from Vietnam that can dry-process 40 tons per hour, has installed a pulper machine and water tank which can wet-dry process 8 tons per hour, has imported Catimor seeds from Vietnam, and has even hired workers from Vietnam to work on the plantation. Approximately 150 farmers, of which 20 are Vietnamese, work on this plantation of over 200 hectares, and still more villagers are hired during the harvest season. Coffee trees in the plantation are applied with carefully managed chemical fertilizers and pesticides. They also have sprinklers, although rainfall in the area is sufficient. This is to bear good coffee cherries by watering trees during the period followed by flowering. The company owner is now eager to export more than simply green beans. She sees an opportunity in exporting roasted coffee and in processing soluble coffee as well. Investments are made to purchase a roasting machine, a processing machine for soluble coffee, and facilities to dry and store a large quantity of coffee produced in the plantation and collected from farmers.

Many of these large-scale producers also collect coffee beans from middle buyers as well as directly

[19] *Café kiao* (pre-harvest loan) generally takes place three to four months before the harvest. There is no contract, usually only an oral agreement. The price offered by the lender is around half of the local market price at the time of the loan.

[20] According to our interviews, the yield of small-scale farmers ranges from 0.5 ton to 1.0 ton per hectare, whereas in large plantations, the yield is around 2 to3 tons per hectare.

from small farmers. Their sensitivity to quality seems to be gradually trickling down to middle buyers and small farmers. Different procurement prices for different quality coffee is certainly the most effective impetus for quality improvement. At this moment, differentiation in quality is observed only partly. When the company collects fresh Catimor and Arabica Typica cherries, they quote different prices for ripe and unripe cherries[21]. Technological insufficiencies are also supplemented at the same time. Some attempts are made by large-scale farmers, such as introducing wet-dry processing prior to official projects, and financially supporting small farmers in building shelves for drying harvested coffee. The large producers are very much aware that quality improvement efforts must be made by all coffee producers in Laos in order to establish a 'good image' for Lao coffee.

V. Changing Local Trade and Marketing

V-1. Local coffee trade

As summarized in Figure 6, coffee produced in the region is either sold to middle buyers or to the company in mainly four different dry-processes and varieties. In the past, except for the period when state-owned exporters had the exclusive right to purchase coffee from farmers, it was generally the middle buyers who sold the collected coffee to exporters. Farmers mainly harvested Robusta and dried it directly in the sun (dry method), then sold it to middle buyers as unshelled 'black fruits'. Unshelled coffee cherries were then transported by middle buyers to the exporters' warehouse to be shelled by machine. If milling machines were available in their village, farmers would mill the black shell and sell the coffee as green beans. This situation has been changing with the introduction of the Catimor variety and the falling price of coffee. Catimor was introduced with the wet-dry method for higher quality. When the wet-dry method is applied, the coffee bean is sold with its parchment (parchment bean). Some importers prefer to import with parchment, or exporters can easily take off the parchment using a shelling (milling) machine before shipping. As the wet-dry method requires additional labor, thus giving higher quality, the price of the wet-dry processed bean is better[22]. Together with Catimor plants, manual pulper machines for taking off the fresh fruit were also distributed or sold to some farmers. Small farmers now also practice the wet-dry method to sell parchment beans at higher price.

V-2. The role of middle buyers

As described above, in the past, farmers generally sold coffee to middle buyers who were either independent or hired by companies (both private and state-owned). The role of middle buyers is also changing with the presence of larger export companies. There are few different ways middle buyers collect coffee from farmers now. First, the middle buyers who represent export companies receive orders from the company to collect a certain amount of a certain variety at a certain price. Middle buyers can

[21]For already dry processed coffee, companies will measure the moisture content and refuse to buy if coffee is not dry enough. However, most farmers mentioned that their coffee beans are bought at the same price regardless of quality.

[22]The wet-dry method is usually suitable for Arabica and Catimor. Farmers stated that for Arabica and Catimor, pulping is easy because of the thickness of the pulp. However, wet-dry processed Robusta is produced in some countries, as well as in Laos in the past, during the French era.

borrow cash in advance for procurement, but there is a risk of price changes after the procurement price is decided with the company. Second, there are middle buyers who have been in the business for some time and have regular farmers from whom to collect coffee. Middle buyers of this type are the ones who lend advance money to farmers (*café kiao*). These middle buyers will only lend money to farmers they know well, and any new borrower must be introduced from reliable sources. Third are middle buyers who engage in middle trading on an irregular basis, as well as middle buyers who have only recently entered the business. The relationship between farmers and middle buyers has been in most part irregular, or a spot trade. Farmers change middle buyers every year according to the different prices quoted by middlemen. Middle buyers also change their coffee collection villages every year according to the villages' varying harvest situations[23].

Though in some aspects the middle buyers have lost business amid competition with exporting companies, they still play an active role in the local coffee trade. Their role is different from that of large export companies. For example, farmers have a tendency to sell coffee to local middle buyers when in urgent need of cash, such as for a festival or a funeral. Middle buyers usually reside within villages and they themselves also produce coffee. Their advantage to export companies is being able to use their connections at the local level when they collect coffee from farmers. They usually have relatives or friends in several neighboring villages. Using these contacts, they can collect coffee more efficiently than large companies. Many middle buyers who collect coffee beans from farmers started their business working for the government collection and trade agent in the 1970's and 1980's. After the mid-1990's when the private sector entered the business, middle buyers also started working with them. Nowadays, some of them represent export companies, while others do business independently. Middle buyers working for a company usually sign a contract with the company on the quantity and the price to be collected. The agreement will take place several times during the harvest season to keep both amounts at a reasonable level. By spreading the agreement across several signings, companies can avoid the risk of sudden price changes during the season. Export companies often provide advance funds to middle buyers. If they sign a large contract to start, companies must prepare a large amount of cash. Once the middle buyer signs with a company, it becomes their responsibility to negotiate the price with farmers. If the market price rises during collection, the loss will be borne by the middle buyers. This is one of the reasons farmers are shifting the sale of their coffee from middle buyers to export companies. To eke out a profit with farmers, middle buyers tend to force down the price or use other methods such as false measurement.

Farmers may prefer to sell directly to export companies; middle buyers provide an important function to farmers as a money lender. Middle buyers have been lending money in a form of pre-harvest lending called "café kiaw" (green coffee). As mentioned earlier, café kiaw is the selling of coffee a few months before the harvest, usually in July and August. Middle buyers usually buy coffee at half the market price at the time of the transaction. When the coffee is harvested, farmers must take the purchased amount to

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[23]One middleman mentioned that because he collects the dried Robusta beans (black fruits); he tries to collect from the village where the weight ratio of coffee bean to pulp is larger.

the middle buyers. Café kiaw is particularly important for small-scale farmers who tend to fall short before the harvest season. It is also important as an emergency fund for unforeseen incidents such as medical needs. These middle buyers also lend money on the usual interest basis. In this case, the interest rate is around 20 percent per month. Farmers who are chronically in need of cash for consumption are the ones who will borrow café kiaw, while farmers who need to borrow for temporary use will choose the usual loan with interest rates. These informal loans from middle buyers have significant meaning for small farmers who do not have access to the formal credit market.

From the middle buyers' point of view, lending café kiaw is both risky and profitable, as the price of coffee may change drastically after purchasing green coffee from farmers. They also face the risk of default by farmers, due to crop damage or other reasons. Most middle buyers only lend café kiaw to farmers they know well. If the farmers are from the middle buyer's same village, the middle buyers have good information on living conditions, coffee garden conditions, and the farmer's personal characteristics. Even if the farmers are from other villages, the middle buyers have pretty good information about the farmer through past experience, such as hiring the farmer for weeding work or having been introduced by someone who can guarantee the condition of the farmer's household. In addition to not lending to strangers, middle buyers also set the maximum amount they would lend to each household, and often keep books. Even with these precautions, they frequently face default by farmers, leading them sometimes to go on a patrol around villages to check the condition of coffee gardens when harvest time is near. There are not only negative sides to middle buyer lending. Although farmers must pay high interest rates or sell coffee at half the market price, if there were no loans or café kiaw from middle buyers, many farmers would not be able to survive. Once farmers gain the middle buyer's trust, the transaction will often develop into a long-term relationship.

V-3. Participation of export companies

In order to stand up to low coffee prices, some exporters began to change the method of collecting coffee beans from farmers. One planter-exporter who owns a large processing facility has begun to collect the fresh red cherries directly from farmers[24]. By using their efficient processing machine, they can cut down the cost of purchasing coffee from farmers. It is also easier for them to control the quality, as they can see if coffee cherries are really ripe or not. The planter-exporter is collecting fresh cherries with different prices for coffee cherries of varying quality. In December 2004, according to an interview with villagers, the company proposed three different prices for Catimor cherries: the highest for fully ripe cherries, a midrange price for fairly ripe cherries, and the lowest for a mixture of ripe and unripe cherries. Farmers view selling fresh cherries as attractive because of the immediate cash income. During this time of the season, farmers are usually in desperate need of cash to purchase food, and to pay the wages of harvest laborers a few months down the road. It is the fastest way to earn cash, as they do not need to wait for dry processing. Many villages, especially those located near the exporters' plantation, began selling

[24]This is observed with Catimor coffee. At the moment, only Catimor and Arabica Typica are wet-dry processed.

fresh coffee fruits[25].

Some export companies are now providing short-term loans directly to farmers. Loans are still limited to large farmers, but they can borrow money for a few months in advance of the harvest and use it to hire weeding and harvesting labor. In some cases, if the loan period is very short (one to two months), the company does not charge interest. In other cases, the company will charge an interest rate of around 5 percent per month[26]. In both cases, farmers have a good incentive to trade with one particular company who will provide them with pre-harvest credit[27]. According to a Pakxong interview, most farmers who can borrow money from a company sell coffee to the same company every year. From the company's standpoint, it is profitable to collect interest and to secure the amount of coffee bought every year. There is also another new transaction between farmers and companies similar to stock options. When selling coffee, farmers with enough coffee beans can choose to store coffee in the company's warehouse. They are guaranteed the price at that time as the minimum price. If the price of coffee increases, farmers can receive the difference[28]. Both credit availability and stock options along with other minor benefits contribute to developing an incentive for farmers to commit to a long-term relationship with a company.

Not only large farmers as mentioned above are selling their coffee to companies, but small farmers also prefer to sell to companies rather than to middle buyers who come to collect in the village. Many farmers complain that middle buyers often cheat them at the time of measurement. When farmers sell to middle buyers, it is measured by volume in tin cans or bags. One common way of cheating is when middle buyers hammer the tin can to gain volume. On the other hand, companies usually measure by weight. Farmers feel it is a fair and better way of measurement. Farmers also state that companies are better with payment; that is, they pay cash on the spot and without delay. Companies also provide farmers with some extra money to buy lunch or cover their transportation costs. The ease of negotiation and small extra benefits attract many farmers to arrange their own transportation and bring coffee to companies' warehouses.

VI. The Market Economy and Lao Coffee

VI-1. Domestic issues

It was not until the mid-1990's that the private sector was encouraged to take part in the coffee business. The government's decision to promote the private sector was in response to preparations for economic integration in the ASEAN region. The private sector quickly acknowledged the profitability of dealing in coffee at the time and invested in large plantations. Accordingly, we can perceive the behavior of large planter-exporters as an indication of market economy activities. In this context, there are several notable contrasts between the market economy-oriented large planter-exporters and small farmers' so-called

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[25]Fresh Catimor cherries must start wet-dry processing soon after the harvest. Thus, cherries can only be sold the same day or early the next day.

[26]Some companies also lend *café kiao*; it depends on the length of the loan. At the time of lending, farmers are asked whether they want to borrow long-term (*café kiao*) or short-term.

[27]However, small farmers usually cannot borrow directly from companies, and the middle buyers' pre-harvest credit mentioned above still plays an important role in informal credit.

[28]Currently, this kind of transaction is done only on a short-term basis, for about two or three months.

“traditional” production methods. Some of these contrasts can be observed from the development of coffee fields, labor use, variety selection, and applied agricultural technologies.

There are two different ways for small farmers to develop coffee fields. First is to open coffee fields gradually in slash-and-burn rice fields. Here, coffee trees, dry-paddy rice, and various upland crops are planted together. When coffee trees grow higher than the rice in the third year, farmers stop rice cultivation and coffee becomes the field’s prominent crop. In this manner, farmers will have other crops to cultivate while the coffee trees are getting ready to bear fruit. Second is what is locally called *café yien* (cool coffee). Coffee trees are planted in the forest where land has not yet been cleared, turning forest trees into natural shade trees. In the *café yien* field, weeds are left behind roots and all; newly planted small coffee trees sometimes cannot compete with weeds, causing some portions to require replanting every year. Villagers consider *café yien* to be unproductive, but they recognize some advantages. In one village, it is practiced near a preservation forest where burning weeds has the risk of spreading the fire into the forest; many farmers also stated that coffee trees planted in *café yien* forests are very soft, hence easy to harvest.

As mentioned earlier, the family is the main source of labor in the small farmer’s coffee field. From time to time, especially during the harvest season, they hire seasonal laborers from the lowland paddy area. For harvest work, laborers are usually hired on a monthly basis[29]. Wages paid to hired laborers fall heavily on the farmers’ households, particularly in years of low coffee prices. Harvesting is the most important and intensive work, for which hiring labor cannot be avoided, thus farmers try not to spend extra expenditures on other field work. Their trees tend to lack sufficient daily maintenance, such as weeding and pruning. Because they work in a labor-saving manner, harvesting is also done in such a way that they often harvest ripe and green cherries together. Other additions like fertilizer are also not sufficient, but farmers try to apply it in a way that will not incur an additional cash expenditure—in this case, by applying coffee pulp or animal manure instead of chemical fertilizers. However, careful investigation is still required to determine whether the farmers’ behavior is based on the lack of labor (a labor market problem), credit constraints (a credit market problem), or the poor reflection of quality on price (a local coffee market problem), or a simple desire to avoid a high amount of input into their coffee crop.

On the other hand, large plantations develop coffee fields in a different manner. In some but not all large plantations, the land is completely cleared upon starting the plantation. They sometimes even clear coffee trees planted by local villagers. In the wide and open land, plantations usually plant Catimor and shade trees in evenly spaced rows according to the promoted way. It is easier for the plantation to manage coffee trees more efficiently if coffee trees are planted in an orderly fashion. Large plantations hire laborers to work the field on a regular basis[30]. Daily maintenance such as weeding and pruning are thus

[29]Hired laborers’ wages for this harvesting season range from 200,000 to 250,000 kip/month. In addition, they receive food, accommodation, and health care, such as medicine. Coffee farmers complain that the wage has been increasing recently because lowland farmers seek job opportunities in Thailand. For weeding, farmers usually hire other farmers from the same village. The wage is usually by the area, from 200,000 to 250,000 kip/ha or 10,000 to 15,000/day (according to a 2003 Pakxong interview).

[30]Permanent workers are hired on a yearly basis. In one plantation, a household receives US$200 to $300/ha/year in return for

done properly. During the busy harvest season, plantations will hire nearby villagers to meet the increased work demand. In large plantations, because the hybrid Catimor is planted, agricultural input such as chemical fertilizers must be applied in order to achieve a high yield. After the harvest, some plantations have good facilities to wet-dry process coffee beans, as well as huller machines to process the dried Robusta coffee cherries they collect from farmers.

Although Catimor begins bearing fruit earlier than other species, during the first one or two years when the plantations cannot harvest coffee, farmers mix all kinds of upland crops into their small coffee fields. Moreover, small farmers usually cultivate not only coffee, but they have different patches of field for planting various vegetables and other cash crops selected according to the price at the time. Plantations often apply chemical fertilizer or animal manure purchased to increase productivity. Small farmers usually only apply coffee pulp and animal manure, but these organic fertilizers will not require any additional expenditures. The development of large coffee plantations involve investment risks, compared to the gradual development of small coffee fields that are managed in a more inexpensive or traditional way. In fact, one of the plantations had cold weather damage the first year they planted coffee trees. The loss of not recovering any harvest from the initial investment and the additional expense for planting new trees has caused such severe damage to the plantation's management that they almost withdrew from the business. This is in contrast to small farmers who have experienced many natural disasters in the past, but never thought to stop growing coffee.

As for the labor, some large plantations have brought changes to the local villagers' livelihood by providing them with cash income opportunities. In one plantation, some families were selected to work on the plantation on a yearly contract. Others are hired on a daily wage basis during the harvest season and for weeding. Consequently, these hired farmers spend less time on their field, and became more dependent on income earned as agricultural laborers It is too early to make any conclusion as to whether the opportunity to work on the plantation is considered a diversification of income sources or a negative side effect of monoculture. What can be said is that the incentive to improve or to take good care of one's own coffee fields is not the same in a village where plantation wage work is available as in a village with no plantations nearby.

VI-2. Lao coffee and the international market

There are two ways to compete in the world coffee market: to supply a large quantity of low-quality coffee at a low price or to supply a limited quantity of high-quality coffee at a higher price. In the Japanese market, for example, green beans[31] imported from Jamaica, home to "Blue Mountain"[32] coffee, have been constantly imported at a high price regardless of falling prices in the global market. In 2001, the unit price of Jamaican green beans was almost 35 times higher than green beans imported from

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taking responsibility of the field.

[31]Pre-roasted coffee beans are called *green beans*.

[32]Blue Mountain coffee is recognized as the highest quality coffee in Japan and has been a consumer favorite for some time.

Vietnam[33]. Considering that Laos is not expected to expand production substantially, the country's goal is to become a high-quality, high-price coffee-producing country. Many exporters and planters already recognize the need to improve quality; however, there is no price incentive for farmers to improve quality, as their coffee is purchased at the same price regardless of quality.

At the moment, the quality of Lao coffee bean is usually checked after having been collected by middle buyers or by exporters. The importers' agents (i.e., exporters and middle buyers) will check the moisture content and other requirements stated by the importers, and if the coffee does not meet the requirements, it will be rejected. Some middle buyers force down the procurement price when working with small farmers in order to avoid the risk of rejection. Since many middle buyers and export companies do not really differentiate the prices of coffee with varying quality, the unwillingness of middle buyers and exporters to export quality coffee is reflected on the farmers' behavior, despite farmers potentially being prepared to produce quality coffee.

One other problem is the lack of information on what coffee consumers in importing countries demand. Large planter-exporters are now investigating the potential market in importing countries, but their information is incomplete. They have recognized that to add value, they should roast the coffee instead of exporting it as unprocessed green beans. It is well known that there is a large discrepancy between the producer price and consumer price[34]. This price difference is added at the roaster's level. It could be a successful strategy, but there is still other information to be taken into consideration. One exporter-planter visited Japan and learned that Japanese consumers preferred a lighter roast than European consumers. She has bought a roasting machine to roast her coffee according to Japanese consumers' tastes. This information is insufficient, however; Japanese consumers are keen about the freshness of their coffee as well as the darkness of its roast. In order to retain freshness, it will be necessary to turn to devices such as vacuum packaging. Japanese consumers also like to consume coffee soon after it is roasted. Therefore, many coffee importers in Japan prefer to import green beans and roast them in Japan. Even if this exporter-planter produces high-quality coffee and roasts it to meet the preference of Japanese coffee drinkers, there is a possibility that the market will still not develop much. If it is difficult for these large exporters to have adequate information about importers' various demands, it will take even more effort for the information to reach small farmers.

Variety selection is another example. Large new plantations are mostly dominated by the Catimor variety thanks to promotional activities carried out by the authorities concerned upon entering the business. Because Lao Arabica Typica did not have a market at the time, the high yield Catimor was chosen as the preferred variety. Recently, small foreign traders have been looking specifically for the

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[33]Based on statistics from the Japan Coffee Association. Green beans imported from Jamaica were 2,258 yen per kilogram versus 65 yen per kilogram from Vietnam in 2001. Note that the statistics did not distinguish the variety. The price discrepancy is assumed to reflect partly the fact that Jamaica is mainly an Arabica-producing country and Vietnam is mainly a Robusta-producing country. However, the Vietnam coffee price is extremely low compared to those countries where Robusta is mainly produced. The production in 2001 was 48,000 bags for Jamaica and 12,600,000 bags for Vietnam.

[34]Oxfam estimates that in November 2001, the price received by the producer was $0.14 per kilogram, the price delivered to the roasting factory was $1.64 per kilogram, and the retail price for an average 1 kilogram of soluble coffee in the United Kingdom was $26.40 (Oxfam, 2002).

original Arabica Typica variety brought into Laos during the French era. One of these traders carefully selects the village and the trees, monitors the harvest and post-harvest process, and purchases the beans at a much higher price than that of other coffee varieties. If the authorities had carefully examined world coffee demand at the time of its promotions Lao Arabica Typica may have had a chance to become a good foreign currency earner.

In order for Laos to export high-quality coffee, it will be essential to install a quality certification system, such as bean grading and coffee cupping. The system must be established by an organization that can provide a formal guarantee. With Vietnamese coffee, many Japanese importers complain that despite Vietnam's own grading system, the quality of the beans varies each time. To develop a long-term trade partnership, there must be trust between the exporter and importer. A good quality certification system is urgent as the exporting country's responsibility. At the moment, there is no official grading or cupping system in Laos. It will be necessary to check the quality of coffee beans in terms of size, moisture content, inclusion of foreign objects (dirt), and other points as well as taste-testing each harvest. Establishing such a system will help reduce transaction costs; if the system is reliable, importers will spend less on inspections. It can also be expected to eliminate rejection costs: there have been many cases where importers have sent back coffee that did not meet their quality standards.

VII. Lao Coffee Perspectives

VII-1. Emergence of coffee entrepreneurs

Coffee production in Laos has been moderate until the recent production increase. The quality of coffee was rather low, making for low traded prices. Although Lao coffee faces many issues as mentioned above, the situation is changing with the emergence of strong entrepreneurship among large exporter-planters. These coffee business leaders play key roles in many aspects of Lao coffee. Their strategy of seeking new markets in foreign countries and their emphasis on quality improvement as impressed upon other farmers in the Boloven Plateau are slowly changing the coffee business in Laos.

One of these entrepreneurs is an exporter-planter who is also an officer of the Coffee Association. He has returned from France where he spent most of his life, entered coffee exporting business in the mid-1990's, and started his own plantation. However, he admits that plantation management is very difficult and that he had to change his business strategy to focus on exporting the finished product (i.e., roasted and packaged coffee). The exporter-planter has clear and distinctive ideas about the business. For example, he engages in activities promoting his roasted coffee, such as opening a French-style café in Pakse where people taste and buy the coffee. He also plans to open a coffee center in Vientiane to provide all kinds of information regarding Lao coffee. He is one of the first exporters to take packaging seriously as a way of adding extra value to coffee. Since he lived in France for a long time, he is quite familiar with the preferences of French and other foreign consumers. As one of his marketing strategies, packages are designed differently according to the target consumer destination. Packages of his coffee feature little "good coffee stories" along with "exotic" pictures of Laos cultural heritage to attract foreign consumers. Other than purely visual design, the package includes a bar code, expiration date, and gas valve to meet international standards. He also utilizes marketing channels unique to the Lao people. His coffee will be sold in Asian supermarkets in the U.S.A. and Australia through his ties with the Lao immigrant communities in these countries.

Another novel feature of the exporter-planter is his attachment to the region and to coffee itself. Many exporters or planters are concerned with nothing more than the profit aspect of coffee, with coffee being only a means of speculation. This exporter-planter, however, has surveyed small producers throughout the region to identify the good-tasting and good-quality coffee in the Boloven Plateau. He insists that large plantations are not always the ones who can produce the best coffee, but rather that some of the best crop comes from small farmers. He has introduced the wet-dry method to small farmers, which is now spreading widely among small farmers prior to more formal projects. In this aspect, he is someone who can perceive Lao coffee from the different viewpoints of a trader, a producer, and a consumer.

The emergence of such eager entrepreneurship is a new phenomenon in the Lao coffee business. They recognize the problems in Lao coffee, are attentive to potential importers' needs, eager to improve their coffee, and always look to gain profit. They are very much aware that it is not only their plantation coffee alone that should be harvested with good quality, but that Lao coffee as a whole also needs to improve in quality to be able to earn a good reputation in the international market. Thus, some efforts to improve local small farmers' quality are already in progress. As mentioned above, some have introduced new post-harvest processing while others have financially supported small farmers in building drying shelves to switch from drying on the ground. It is expected that these leaders will play an important role in transferring consumer information in importer countries to producers in the field.

VII-2. Traditional methods of coffee production

The main producers of Lao coffee are the small farmers who have been incorporating coffee cultivation into their local agricultural system. Small farmers have developed coffee fields, selected coffee varieties, used labor, and applied techniques that have not always been efficient in terms of productivity, but that seem to be well adapted to the given ecological and socioeconomic conditions. Crop diversification is also an example. The small coffee farmers in the Boloven Plateau do not stake their ways of living on coffee alone. They often cultivate various cash crops and sometimes upland rice along with coffee. During the low price years, farmers abandon coffee trees[35] and shift their efforts to other crops. They know from experience that the price of coffee fluctuates, so they merely take action to clear the field for planting other crops that are more profitable commodities at the time. This is in contrast to some farmers in Vietnam, for example, who are attentive to prices and switch all their crops to the one with the highest value at the time.

With regards to variety selection, Arabica Typica or Catimor are apparently the higher-priced varieties. Some farmers prefer to grow Robusta, however, although their land is also suitable for planting Catimor coffee. Farmers cite the longevity of Robusta trees, their disease- and cold-resistant quality, and the large

[35]This is one of the important reasons farmers prefer to grow Robusta coffee. Robusta trees can survive for many years without care, and once farmers resume tending to them, the trees will bear coffee again.

initial investment and input required for Catimor. This decision-making seems to imply that coffee farmers, particularly small farmers, tend to avoid the risks of sudden loss or large investment. Such cautious behavior appears to have been sheltering small farmers from the potential impact of low world coffee prices. Many improvements in farming techniques are still needed, but the careful attitude towards adapting new techniques can be an advantage to small farmers.

VIII. Concluding Remarks

Lao coffee production is now at a crucial turning point. It is facing severe competition with other coffee-producing countries with their ever-increasing production. It is facing changing trade conditions, such as the implementation of the AFTA scheme. The basic direction new large planter-exporters are taking—that is, a quality-oriented strategy—is probably the right one. Because Laos is a small coffee producer, it is important to focus on the market to which they want to sell their coffee. On one hand, there are countries like Brazil and Vietnam that produce a high quantity with varying quality. It is wiser for Laos to choose to produce high-quality coffee, for it is difficult to compete with these countries in terms of quantity. It is important as a small producing country to gain a good reputation. In the future, it will become necessary to establish some kind of quality standard system.

The geographical peculiarity of Laos also needs to be taken into consideration. Laos is surrounded by the economic powerhouses of China, Vietnam, and Thailand. In many cases, these countries produce the same agricultural products produced in Laos, thus the ever-present possibility of competition with these neighbors. Coffee is produced in all three countries, but their strategies seem to be different. For example, according to the AFTA-CEPT schedule, Thailand put green coffee beans on the sensitive list and Vietnam put instant coffee on exclusion list (Table 12). It probably reflects different strategies in the two countries. Thailand has already established a foreign-affiliated coffee processing industry, and now places emphasis more on protecting coffee-producing farmers. Vietnam, on the other hand, produces a large amount of coffee and is often considered to be oversupplied, but has just begun promoting a processed coffee industry. These policy trends in neighboring countries will certainly influence coffee exports from Laos. The general argument can be extended to other agricultural commodities. When the issue is seen more locally, as we noted in the case of tea produced in Phongsaly for export solely to China, agricultural production in different regions is heavily influenced by its neighboring countries. Tea production in Phongsaly has a clear market in China; production, processing, and marketing are all done to meet the demand in China. Many agricultural products such as maize, sesame, and Job's tears also depend on the demand and domestic production situation in Thailand, China, and Vietnam. On the other hand, coffee is exported mainly not to these countries but to European countries, with no single main market yet. It will mean that when policy is discussed, each agricultural commodity must be studied carefully and separately for its characteristics with regard to production, demand, and the possible market.

For a long time, Lao coffee farmers have been producing coffee and other agricultural crops in what may be called a "traditional" way. In this traditional way, farmers integrated ecological conditions, the availability of labor, and the crop diversification unique to the region. Although quality improvement is urgently needed, it should be recognized that the way of farming practiced by farmers in the region has its own advantages. Other than advantages for the farmers, such as coordinating the labor supply and reducing the risk of coffee price changes, small farmers' ways of agriculture may bring significant value to Lao coffee. For many importers, it has now become an attractive feature of Lao coffee that small farmers almost never apply chemical fertilizers and pesticides to their field. In many coffee-importing countries, consumers are becoming more and more conscious about the safety of the food they consume. They are concerned with how the product is produced and who produces it. Therefore, it is meaningful to understand the farmers' behavior; for the future prospects of Lao coffee, the traditional way of farming is subject to further study.

Besides the issues mentioned, the role of coffee production in the local economy is an important subject. Coffee producers frequently hire farmers from the lowlands. These laborers often come not only from the nearby lowlands, but also from distant areas seeking seasonal employment. The relationship or coordination between coffee farmers and these lowland laborers still needs further investigation, but it is certain that coffee production is providing some people with supplementary income.

Lao coffee still has a long way to come before it is recognized amid the intense global competition. However, it is important not to rush. Lao farmers have been adapting themselves slowly but surely. Now, with new entrepreneurs who can connect the farmers to the world market, there is a good chance that coffee will come to play an even more important role in the Lao economy.

Appendix

1. Current Coffee Production in Pakxong, 2004

In the Pakxong District, the production of Robusta[36] coffee is expected to be low for this coming season of 2003 and 2004 due to low rainfall during the flowering season. Farmers pointed out this problem in many of the villages we visited. Robusta accounts for more than 90 percent of the region's coffee production, thus the low yield of Robusta coffee will affect most coffee farmers in Pakxong. Combined with the stagnant low price of coffee, farmers in Pakxong will probably face even lower income from coffee this season. In addition, there is also the problem of an insect that eats coffee fruits: the coffee berry borer (CBB), one of the most difficult pests to control. CBB eats coffee fruits from the inside and can survive the drying process. Coffee beans eaten by these insects cannot be sold. If CBB is not properly removed, the insect's eggs will survive into the next season, thus the damage will continue and increase. The insect has been recognized for the past few years, but the damage has become more conspicuous in many villages this year.

There are mainly two ways to control CBB. The first is to apply pesticide; the second is to clean and

[36]There are chiefly four kinds of coffee grown in Pakxong. They are Arabica Typica, Catimor, Robusta, and Liberica. Robusta is usually processed into soluble coffee or canned coffee, and its traded price is lower than that of Arabica Typica or Catimor. Liberica is produced in very small amount in the world for its distinct flavor. Laos exports Liberica solely to Cambodia and a few Middle Eastern countries. The price of Liberica is thus much lower compared to that of the other three varieties. However, Liberica was sold at a good price this last season at around 4,500 kip/kg, compared to that of 2003, 2,500 to 3,000 kip/kg.

keep the coffee gardens in good sanitary condition[37]. In addition, it will be necessary to foster healthy coffee trees. The Ministry of Agriculture and Forestry has shown concern regarding the issue of CBB and organized a workshop for the southern coffee-producing provinces (May 2003). However, these efforts do not seem to be reaching down to the provincial and district levels yet. For example, the use of Endosulfan[38] was recommended at the workshop, but due to technical difficulties and the pesticide's limited availability[39], actual usage is still limited to 160 ha of coffee gardens, according to the Ministry. Many coffee farmers still lack adequate information about CBB and how to exterminate it.

There are some difficulties in controlling CBB that are peculiar to Laos. In addition to the pesticide unavailability, farmers often complain that they do not have enough money to purchase it. Most coffee trees grown in the region are kept tall, and their height makes pesticide application difficult even if farmers should be able to obtain it. The field sanitation method requires a substantial amount of labor. In labor-scarce Lao, coffee farmers often need to hire agricultural labor for harvest and weeding. Maintaining a clean coffee garden to control CBB will require additional labor that will place another expenditure burden on farmers. Weak government agency extension services are another factor. Many farmers still do not understand that the insects will keep damaging their coffee for a long time if not treated properly. Although the central government provided some information to local governments, they cannot give enough extension service to farmers. There is information that the FAO (Food and Agriculture Organization) project to improve coffee quality in the region will try to deal with the issue of CBB as well. In any case, coffee farmers in Pakxong are at risk of a production drop this year.

2. General Export Procedures

For any export transaction, a company or exporter is required to carry out a series of procedural steps. In general, before the shipment of goods, the company has to obtain some official documents or certificates from authorized provincial organizations such as the Commercial Office and the Finance Office, plus some related offices such as the Agricultural and Forestry Office and the Science, Technology, and Environment Office. According to government import-export instruction number 24/PM dated 22 September 2004, the procedure of issuing documents and certificates from those offices must be simplified so that only one counter and one signature is required from each office and that each office's document must be completed within 1-2 business days. For the export transaction of normal goods, the exporter must present the invoice and packaging certificate to the one-stop service unit for inspection and approval. The set of required documents might be different depending on the various categories of goods classified by the government, such as goods monitored by the Ministry of Commerce, prohibited goods, goods monitored by other ministries, and so on. In order to get export permission for these three

[37]All coffee fruits with CBB, both on trees and on the ground, must be picked and burned. Gardens should be kept clean to prevent even further spreading.

[38]Endosulfan is a powerful but dangerous pesticide, the most effective on CBB.

[39]Because of possible dangers to human health, the import and sale of endosulfan is strictly controlled. If farmers want to buy the pesticide, they will first have to register with the local government office. These procedures and the physical availability of the pesticide are some of the reasons for its limited use.

categories, along with those two documents, the exporter must also submit a letter to the Department of International Trade, the Prime Minister's Office, or the appropriate ministries and provincial offices, depending on the category to which the goods belong. Then the goods must receive a technical quality check inspection before proceeding to the one-stop service unit at the border checkpoint. The list of goods and concerned authorities is shown in the table below.

In order to make import and export transactions more convenient and effective, the government introduced a decree on import-export management in July 2001. Its main objectives are to lessen the comprehensive procedures for exporters and importers at the border checkpoint by setting up the so-called *One-Stop Service Unit*. This unit is where export and import authorities, such as the trade service section, custom-tax section, and other representatives of related organizations (the transport section, agricultural section, and others), are gathered in one place for exporters and importers to receive more convenient service. The unit's office is located within the border checkpoint area, near the storage facilities, or in the special economic zone. After issuing this decree, there were many follow-up notices and instructions issued by the Minister's Office and the Ministry of Commerce in September and October 2004 to run the one-stop service unit more effectively. These include instructions on facilitating import-export transactions and goods circulation within the country, a notice on import and export procedures, a notice on imports and exports, and so on. In the latter notice, it was announced that import and export licenses were abolished for all goods except gold and copper.

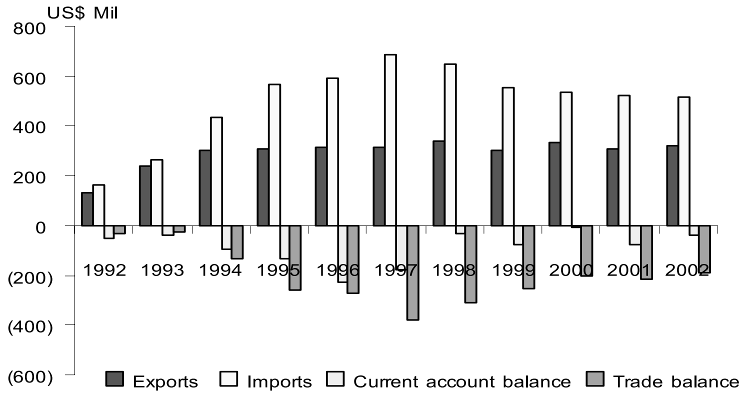
When goods for export are transported via certain provinces before arriving at a designated border checkpoint, transit provincial authorities do not require exporters to carry out any export procedures; rather, once at the checkpoint's one-stop service unit, they can present official documents obtained from the appropriate authorities in their province of origin.

No.	Items	Related Organizations
1	Valuable goods (diamond: 721:02)	- Department of Foreign Trade, Ministry of Commerce and Tourism
2	Mineral (25.02-22; 25.24-30; 26.01-21)	- Department of Geology and Mines, Ministry of Industry and Handicraft - Provincial trade office
3	Seeds and Seedlings	- Department of Agriculture, Ministry of Agriculture and Forestry
4	Animals and Animal Products	- Department of Livestock and Fisheries, Ministry of Agriculture and Forestry
5	Timber Products	- Department of Forestry, Ministry of Agriculture and Forestry - Provincial trade office
6	Forestry Products	- Department of Forestry, Ministry of Agriculture and Forestry
7	Goods monitored by other ministries for a certain period	- To be announced by respective authorities

Source: Ministry of Commerce and Tourism

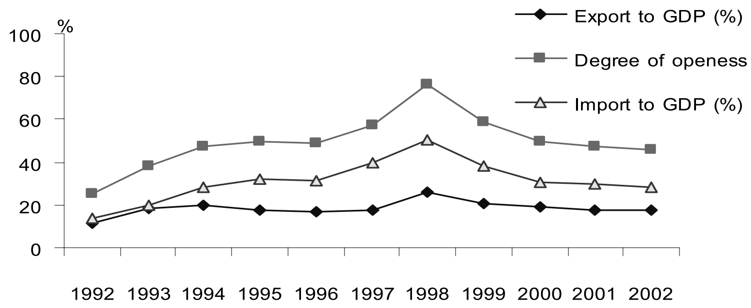
Figures and Tables

Figure 1. Trade Balance, 1992-2002



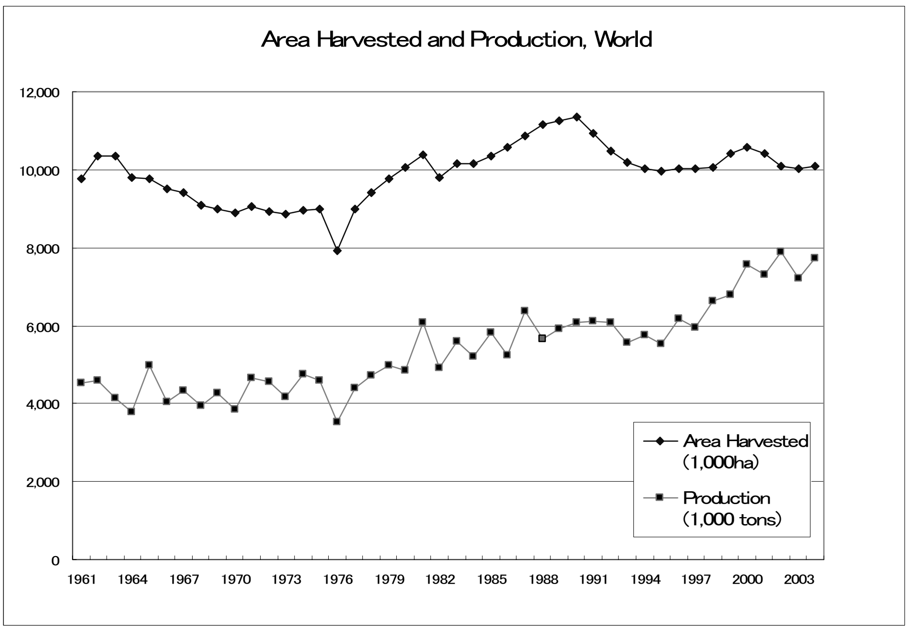
Source: National Statistic Center, Lao PDR

Figure 2. Export and Import to GDP (percent)



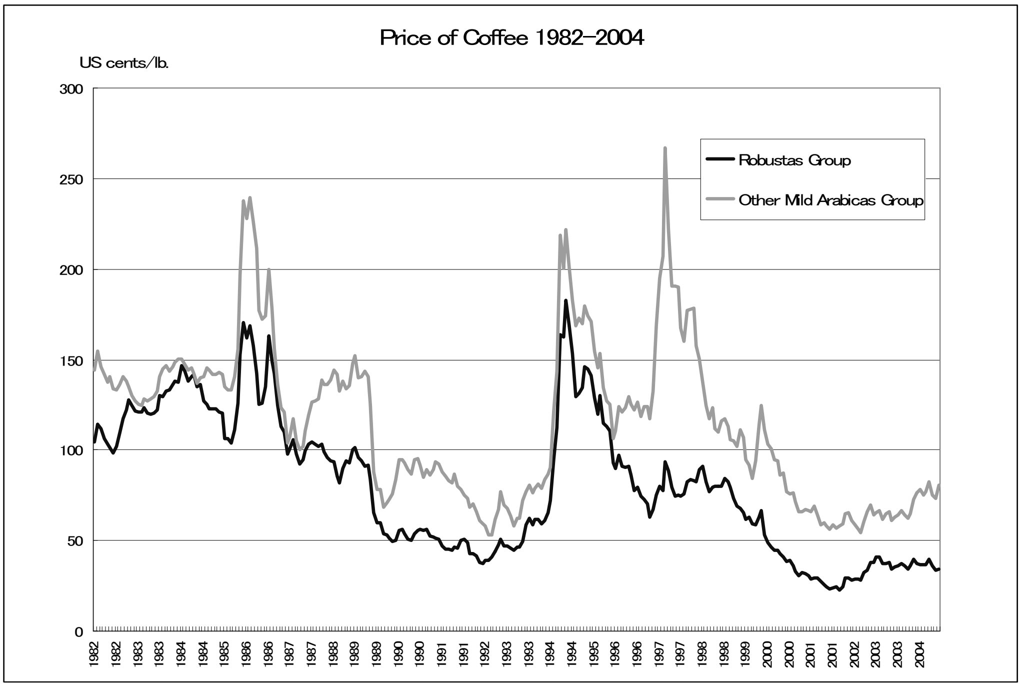
Source: National Statistic Center, Lao PDR

Figure 3. World Trends in Coffee Production



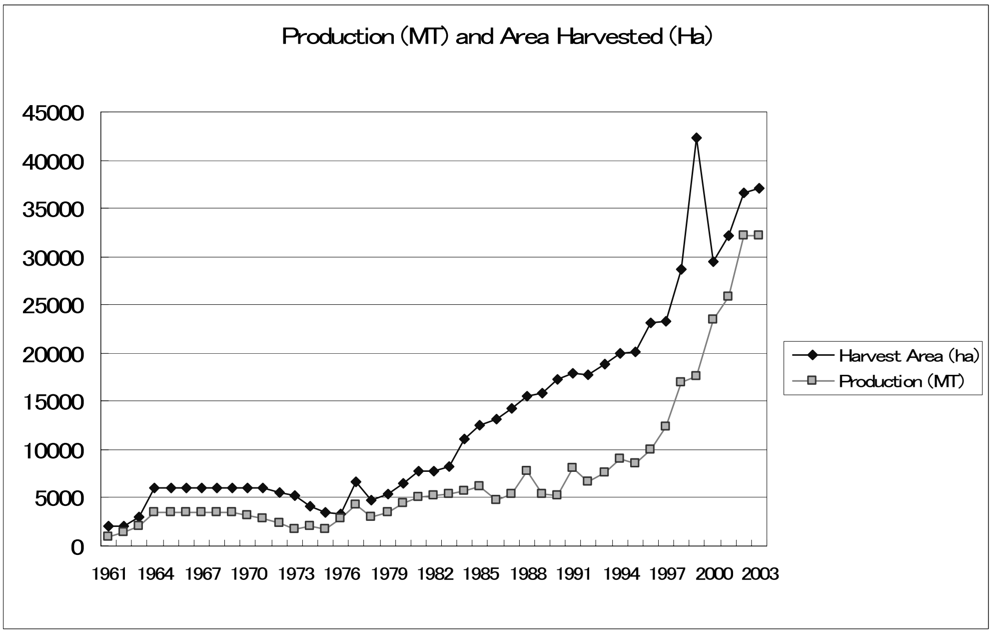
Source: FAO, FAO STAT Agricultural Data.

Figure 4. World Price Trends



Source: International Coffee Organization

Figure 5. Production Trends, Lao PDR



Source: FAO, FAO STAT Agricultural Data

Table 1. Exports by Country/Region of Destination 1990-2000

Unit: percent

Destinations	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
ASEAN	49.80	56.57	39.61	42.05	28.29	24.68	25.17	22.06	15.74	27.70	31.68
- Thailand	49.58	56.25	38.83	41.74	26.90	21.40	23.77	21.50	15.38	24.04	30.81
- Singapore	0.00	0.00	0.46	0.23	1.11	3.27	1.30	0.30	0.34	3.59	0.36
- Rest of ASEAN	0.22	0.32	0.32	0.08	0.28	0.01	0.09	0.26	0.02	0.07	0.50
European Union	5.28	29.15	30.21	32.59	25.10	31.51	28.24	37.51	49.77	47.44	48.53
USA	0.44	2.49	5.98	6.03	3.70	3.38	6.08	5.77	10.79	5.67	4.26
Japan	5.11	5.34	11.51	7.68	12.09	9.08	8.12	8.06	9.75	5.79	4.92
China	6.95	2.66	3.48	2.32	1.71	1.98	2.83	2.22	3.86	4.07	2.64
Taiwan	0.30	1.02	3.83	4.17	5.54	5.51	3.21	4.47	2.95	2.38	1.19
Australia	0.05	0.08	0.01	0.01	0.01	0.03	0.08	0.03	0.10	0.17	0.22
Norway	0.89	0.57	0.30	0.34	0.52	1.53	1.30	1.54	1.95	1.26	1.11
Rest of world	31.19	2.13	5.07	4.82	23.04	22.31	24.96	18.33	5.08	5.52	5.45
Total	100	100	100	100	100	100	100	100	100	100	100

Source: *Composition and Evolution of Lao PDR's External Trade*, UNIDO International Program for Lao PDR, UNIDO/MIH, Vientiane, 2002.

Table 2. Exports of Major Commodities, 1990-2000

Unit: percent

SITC	Commodities	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
0	Food and live animals	16.59	2.90	5.21	5.54	4.76	9.88	6.95	11.30	13.23	13.03	11.29
07	**- Coffee**	**16.32**	**2.62**	**3.26**	**4.45**	**3.11**	**7.82**	**4.96**	**9.57**	**12.58**	**10.27**	**7.85**
	- Other products	0.26	0.28	1.94	1.09	1.64	2.06	2.00	1.74	0.64	2.76	3.44
1	Beverages and tobacco	0.00	0.00	0.07	0.00	0.40	0.30	0.28	0.29	0.03	0.02	0.08
2	Crude materials	55.86	63.08	54.30	50.97	44.16	34.85	34.74	31.18	26.21	30.23	33.88
24	- Wood	42.33	54.43	48.21	48.09	41.49	32.61	32.32	28.97	23.25	27.00	31.39
	- Other products	13.53	8.65	6.10	2.87	2.67	2.24	2.42	2.21	2.96	3.23	2.49
3	Fuel and lubricants	0.03	0.00	0.17	0.29	0.01	0.22	0.40	2.95	0.33	1.19	0.57
4	Animal, veg. oils, fats	0.00	0.00	0.00	0.00	0.02	0.02	0.02	0.01	0.00	0.05	0.00
5	Chemicals	0.19	0.08	0.22	0.74	0.71	1.56	0.57	0.67	0.11	0.10	0.17
6	Manufactured goods	17.90	2.39	2.99	3.60	3.55	7.39	4.15	4.92	2.90	2.84	1.98
63	- Wood manufactures	14.13	1.06	1.95	2.36	1.93	2.79	2.63	3.08	2.13	1.66	1.41
	- Others	3.77	1.33	1.04	1.24	1.62	4.60	1.52	1.84	0.77	1.17	0.57
7	Machines, transport equipment	0.91	0.50	0.74	0.97	1.07	0.87	0.96	0.58	1.86	0.69	0.51
8	Misc. manufactured products	7.48	30.22	35.90	37.75	45.10	44.68	51.62	47.49	54.49	51.14	50.77
82	- Furniture	0.06	0.39	0.47	0.37	2.70	2.51	3.05	2.08	0.42	0.46	0.28
84	- Clothing and accessories	6.85	28.52	35.07	36.87	37.00	36.43	41.82	41.73	53.24	49.97	49.61
85	- Footwear	0.02	0.00	0.06	0.01	4.15	4.12	5.25	2.96	0.61	0.44	0.73
	- Other products	0.54	1.31	0.30	0.50	1.25	1.62	1.50	0.72	0.22	0.28	0.14
9	Goods not classified	1.04	0.82	0.39	0.14	0.22	0.24	0.30	0.60	0.84	0.72	0.74
	Total	100	100	100	100	100	100	100	100	100	100	100

Source: *Composition and Evolution of Lao PDR's External Trade*, UNIDO International Program for Lao PDR, UNIDO/MIH, Vientiane, 2002.

Table 3. Related Coffee Statistics in 4 Coffee-Producing Provinces, 1998/99

Provinces	Total		Plantations		Scattered Fields	
	Number of producers	Number of trees	Number of producers	Number of trees	Number of producers	Number of trees
Champasack	11,961	49,440,605	11,685	49,326,338	276	114,266
Sekong	3,166	2,362,632	3,007	2,359,575	214	3,057
Attapeu	150	34,372	104	32,805	45	1,567
Saravanh	6,794	10,878,957	6,678	10,875,879	143	3,078
Total	*22,071*	*62,716,566*	*21,474*	*62,594,597*	*678*	*121,968*

Source: *Agricultural Statistic Survey, 1998/99: Champasack, Sekong, Attapeu, and Saravanh Province,* National Statistic Center, Lao PDR.

Table 4. Production of Green Beans (Mt) in Coffee-Producing ASEAN Countries and China

Area Harvested (ha)
Production (Mt)

	1973		1983		1993		2003	
	Area	Production	Area	Production	Area	Production	Area	Production
Cambodia	364	124	180	80	250	180	370	300
China	7,592	6,017	13,000	6,000	7,000	4,000	16,000	21,000
Indonesia	266,000	150,163	539,000	305,648	810,000	438,868	1,001,603	702,274
Laos	5,300	1,800	8,240	5,320	18,901	7,622	37,000	32,200
Malaysia	13,000	4,920	14,990	11,900	14,643	11,100	50,000	40,000
Myanmar	2,332	1,026	2,707	1,195	3,268	1,220	5,000	2,600
Philippines	60,790	50,910	137,340	146,927	140,701	123,933	135,000	110,000
Thailand	3,815	2,240	24,896	18,035	72,480	70,426	66,400	53,703
Viet Nam	15,000	6,600	11,990	5,700	71,600	136,100	500,000	771,200

Source: FAO, FAO STAT Agricultural Data.

Table 5. Harvested Area and Coffee Produced in the Boloven Plateau

Area harvested (ha)
Production (ton)

		1976	1980	1985	1990	1995	1996	1997	1998	1999	2000	2001	2002
Saravan	Production	950	1,545	935	935	1,421	2,240	3,000	4,929	5,130	7,520	8,096	9,738
	Area Harvested	1,600	2,532	1,558	3,366	4,875	7,400	7,100	8,500	13,820	9,400	10,120	10,942
Sekong	Production			570	432	500	600	825	1,200	1,213	1,624	1,880	3,395
	Area Harvested			758	1,080	1,243	1,440	1,500	2,000	2,850	2,030	2,350	3,772
Champasack	Production	1,830	2,850	4,560	3,686	6,639	7,075	8,420	10,800	11,100	14,098	15,636	18,862
	Area Harvested	1,800	3,912	10,130	12,349	14,012	14,150	14,630	18,000	25,070	17,600	19,520	21,680
Attapeu	Production		4	3	9	15	21	15	17	17	161	184	202
	Area Harvested		7	6	13	25	30	30	30	30	230	230	230
Total	Production	2,780	4,443	6,144	5,322	8,576	10,020	12,300	16,999	17,530	23,500	25,796	32,197
	Area Harvested	3,400	6,532	12,595	17,277	20,158	23,145	23,345	28,640	42,250	29,400	32,220	36,624

Source: Yearly Statistic Report, Ministry of Agriculture and Forestry

Table 6. Major Commodities of Lao PDR (Million US$)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Wood Products	65.8	96.1	88.3	124.6	89.7	115.4	84.9	87.1	81.0
Agriculture	9.2	12.1	13.7	17.8	18.1	8.4	8.3	15.4	12.6
Coffee	**4.1**	**3.1**	**21.3**	**25.0**	**19.2**	**48.0**	**15.2**	**12.1**	**7.8**
Manufactures	38.1	36.3	43.3	27.9	15.2	10.1	27.9	9.6	9.7
Garments	49.0	58.2	76.7	64.2	90.5	70.2	72.0	91.6	100.0
Motorcycle	36.0	46.2	17.7	12.5	17.1	17.8	38.4	22.1	23.4
Electricity	19.6	24.8	24.1	29.7	20.8	66.5	90.5	112.2	114.2
Total exports	240.5	300.4	312.8	320.7	316.9	337.0	342.1	351.0	349.8

Source: *IMF Country Report 2002 and 1998.*

Table 7. Production and Export by Variety

Year	Production(Mt)		Export (Mt)	
	Robusta	Arabica	Robusta	Arabica
1995	8,500	200	8,320	149
1996	7,600	300	7,390	292
1997	14,000	350	13,000	312
1998	14,500	320	13,800	296
1999	15,000	250	14,000	195

Source: Coffee Exporters' Association, Laos

Table 8. Coffee Statistics of Champasak Province

	2000	2001	2002	2003	2004
Area Planted (Ha)	25,152	26,902	27,310	29,142	29,200
Harvested Area (Ha)	16,846	18,788	19,524	22,285	22,300
Yield (Ton/Ha)	0.76	0.81	0.79	0.80	0.81
Production (Ton)	13,605	15,188	15,333	17,437	18,063
Export (Ton)*	19,743	22,634	19,207	20,851	23,890

Source: Chamapasak Province, Department of Agriculture and Forestry
*Figures include Chamapsak, Saravan, and Sekong Provinces.

Table 9. Coffee Exports

Quantity (Mt), Value (US$1000)

	Laos		Brazil		Viet Nam		World	
	Quantity	Value	Quantity	Value	Quantity	Value	Quantity	Value
1961	90	30	1,018,234	710,386	173	80	2,726,281	1,852,101
1970	842	177	962,629	939,266	2,344	1,340	3,251,165	3,045,963
1975	380	760	781,990	854,513	2,300	3,200	3,519,235	4,153,525
1980	1,219	1,915	784,465	2,486,055	4,019	4,832	3,677,327	12,081,220
1985	4,351	10,950	1,033,611	2,369,178	9,200	13,800	4,301,787	10,822,007
1990	5,900	11,800	853,230	1,106,287	89,583	92,493	4,844,335	7,004,648
1995	9,914	25,100	721,305	1,969,869	248,100	596,000	4,239,717	12,277,655
2000	16,990	18,700	967,042	1,559,614	733,900	499,651	5,498,964	8,461,539
2003	13,959	10,973	1,369,159	1,302,746	749,200	330,000	5,233,064	5,545,748

Source: FAO, FAO STAT Agricultural Data.

Table 10. Coffee Harvested Area by Province

Unit: ha

Province Name	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Lao PDR	18,901	20,021	20,158	23,145	23,345	28,640	29,250	29,402	32,220	36,624	29,122
Northern Region	259	786		100	70	76	85	26			103
Phongsaly	108	113						4			
Luangnamtha											13
Oudomxay	54	54		50							53
Bokeo											
Luangprabang	50	560		50	65	71	75	22			37
Huaphanh	41	42			5	5	10				
Xayabury	6	17									
Central Region	46	45	3	25	15	34	35	116			38
Vientiane.C						5					
Xiengkhuang	16	16					5				38
Vientiane											
Borikhamxay											
Khammuane	30	29		10	15	15	15	116			
Savannakhet						14	15				
Xaysomboon			3	15							
Southern Region	18,596	19,190	20,155	23,020	23,260	28,530	29,130	29,260	32,220	36,624	28,981
Saravan	3,248	4,012	4,875	7,400	7,100	8,500	8,550	9,400	10,120	10,942	3,324
Sekong	1,913	1,200	1,243	1,440	1,500	2,000	2,020	2,030	2,350	3,772	3,372
Champasack	13,417	13,955	14,012	14,150	14,630	18,000	18,530	17,600	19,520	21,680	22,285
Attapeu	18	23	25	30	30	30	30	230	230	230	

Source: Food and Agriculture Organization

Table 11. Coffee Production by Province Unit: ton

Province Name	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Lao PDR	7,622	9,035	8,576	10,020	12,300	16,999	17,530	23,500	25,796	32,197	22,218
Northern Region	142	741		68	30	34	50	15			77
Phongsaly	66	70						2			
Luangnamtha											8
Oudomxay	35	35		40							32
Bokeo											
Luangprabang	12	600		28	28	32	45	13			37
Huaphanh	26	27			2	2	5				
Xayabury	3	9									
Central Region	23	24	1	16	10	19	20	82	–	–	30
Vientiane.C						3					
Xiengkhuang	6	7					2				30
Vientiane											
Borikhamxay											
Khammuane	17	17		7	10	9	9	82			
Savannakhet						7	9				
Xaysomboon			1	9							
Southern Region	7,457	8,270	8,575	9,936	12,260	16,946	17,460	23,403	25,796	32,197	22,111
Saravan	821	1,253	1,421	2,240	3,000	4,929	5,130	7,520	8,096	9,738	2,260
Sekong	720	720	500	600	825	1,200	1,213	1,624	1,880	3,395	2,023
Champasack	5,903	6,280	6,639	7,075	8,420	10,800	11,100	14,098	15,636	18,862	17,828
Attapeu	13	17	15	21	15	17	17	161	184	202	

Source: Food and Agriculture Organization

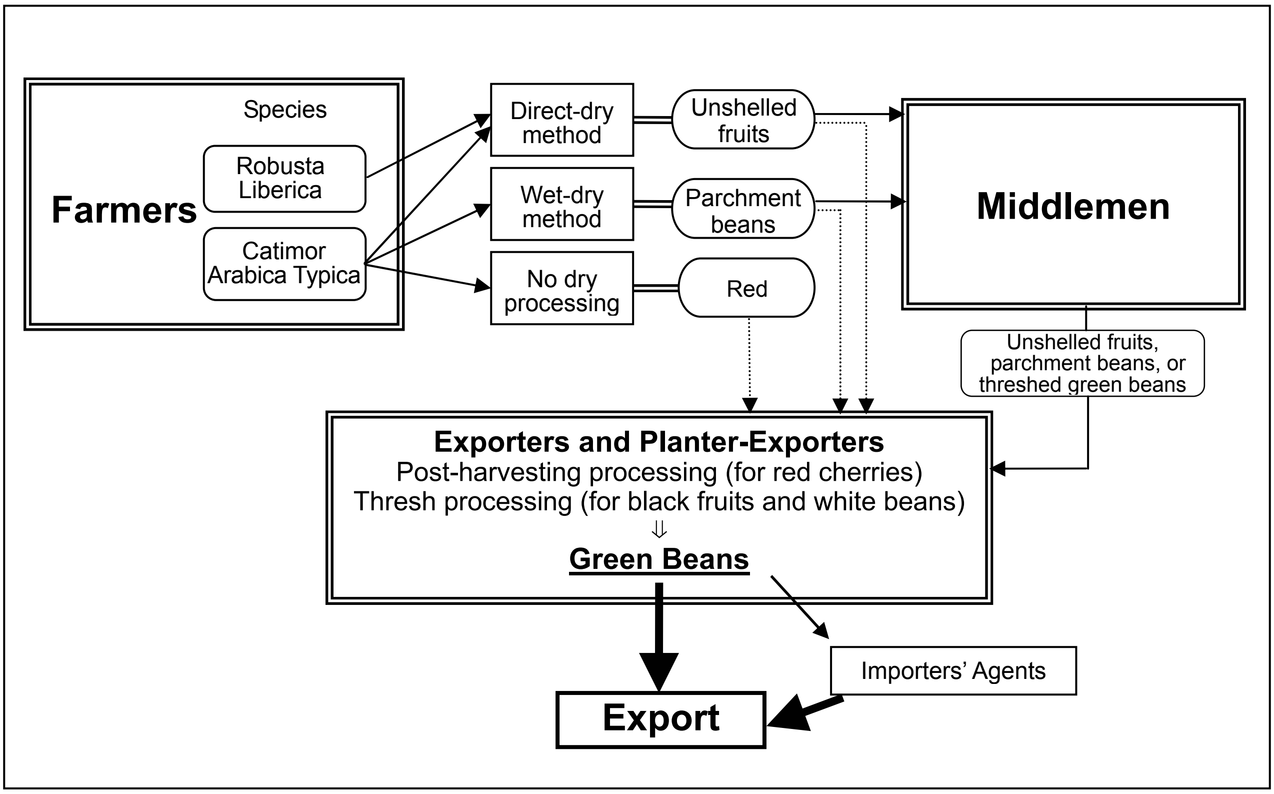
Table 12. AFTA-CEPT Scheme of Coffee

	Coffee, not roasted	Coffee, roasted	Instant coffee	Coffee extracts
Brunei	S	S		N
Cambodia	E	E		E
Indonesia	N	N		N
Laos	N	N		N
Malaysia	S	N		N
Philippines	N	N		N
Singapore	N	N		N
Thailand	S	N	N	N
Viet Nam	N	N	E	E

Note: S Sensitive list, N Normal track, E Exclusion

Source: Consolidated 2002 CEPT Package, ASEAN Secretariat.

Figure 6. An Illustration of the Local Coffee Trade



Source: Illustrated by author

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7. Economic Integration of Lao Economy: Case Study on the Lao Cement Industry

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Summary

Lao PDR became a new member of ASEAN in 1997, and it has to implement the AFTA scheme completely by the year 2008. It means: by the year 2008, all items of the current Temporary Exclusion List (TEL) are to be shifted to the Inclusion List (IL), the tariff rates of which are going to be between 0-5 percent. This means there will be no protection for domestic production in particular in manufacturing and service sectors. In this context, the Lao cement industry is of concern. The main question is how the Lao cement industry could survive under AFTA scheme if there is no protection by the government. In this sense, the assessment of the impact of AFTA accession on the Lao cement industry has been taken into account in order to provide information to meet the needs for future developmental planning of the Lao cement industry as an example for other domestic industries with similar conditions.

In according to serve for this issue, this report on cement industry is divided into five parts.

The first part provides general background information related to Lao cement industry under the AFTA scheme and Lao's commitment under CEPT. There will be an overview on Lao PDR a short description of the cement industry.

The second part focuses on cement development in the Lao PDR. This part discuss the cement market situation in particular, and it also introduce a new cement plants and other biggest one is in the constructing process in the southern part of Lao PDR.

The third part discuss on the cement production, imported cement and domestic demand for cement consumption. Cement outreach of the 2 plants in Vangvieng can cover the market within 300 km distance namely: Vientiane Capital, Vientiane, Bolikhamxay, Luangprabang, Xiengkhuang provinces and Xaysomboune Special Zone, while the new one a Savannakhet can initial supply in the province. However, Lao PDR still import cement from Thailand about 80% of the total cement import in 2003.

The fourth part deals with developmental potentiality of the Lao Cement Industry on raw material resource, hydro power from Namgum dam, the both cement plants located in the centre of Lao PDR and for the long run, it can expand to the regional market because it is located in the South East Asia Regional. Together with this, the quality of cement product from Vangvieng Cement Plant no II meet the international standard. However, the cement industry in Lao PDR still face with the constraints mainly on price determined that control by the state which can not be flexed to the market mechanism, high

transport cost lead to the increasing of the high price, limited weigh loading of a container of goods, quality of cement plant no I could not compared with international standards, Lao cement plants are small scale and they are not in the sense of economy of scale which compare to Thai cement plant.

And in the final part, conclusion of the cement industry discuss that:

- Domestic cement market's share over the country is relatively small, but will increase more than 4 folds by early 2007 after completing the on going cement plant construction in Khammoune and in Saravanh province.
- At present the Lao cement industry can supply cement commodities with largest market shares to domestic markets in particular those are close to the Vangvieng Cement Plants I & II, but in many provinces, they still need to import cement from neighbouring countries.
- The trends of market demand for cement in particular for public infrastructure as well as for business and household consumption in the Lao PDR are growing rapidly. This will offer market opportunity for the Lao cement industry. However, under AFTA/CEPT scheme, the Lao cement industry will face cheaper imported cement by tariff reduction to 0 per cent after 2008.
- In terms of price competition, if import tariff for imported cement reduced to 0%, Lao cement commodities can compete with Thai cement in Vientiane Capital, but not in Southern part of Lao PDR. 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 by the Cement Plant No. II are accepted to compare with international standards; i.e. competitive quality. However, the cement products by the Cement Plant No.I are under international standards.
- In terms of comparative advantages, Lao cement industry has potentials in material resources and labor cost, while it has disadvantages in high transportation cost, high cost of technology, spare parts, equipments, inflation, unstable exchange rate, debt burden etc.
- Expected benefits from AFTA/CEPT for the Lao cement industry is cheaper import of input factors (raw material, spare parts, vehicles...)
- After 2008 by fully implementing AFTA/CEPT commitment of Lao PDR, assumption for keeping the current price of domestic cement commodities, in particular cement supply in markets far from the Vangvieng Cement Plants, prices of cement produced in Southern part and the current quality of cement products of the Vangvieng Cement Plant I, it could not compete with imported cement from Thailand.

Through the conclusion we have some Recommendation for the producer and the government of Lao PDR. The Lao cement producers should prepare measures for the integration in order to adjust to their competitors or at least to survive, in particular they might:

- improve capacity of cement production especially: to improve quality of cement products, to minimize production costs by reducing unnecessary cost which is aiming at reducing sell prices to be competitive. Together with this it should also improve its management, organization and productivity of cement production,
- upgrade and train workers and staff of the Lao cement industry in accordance with the need for the modern production, management and marketing,
- study comparative advantages of their competitors in neighboring countries,
- look for new markets in the country, but also in neighboring countries,
- establish research and development division on cement production and marketing,
- develop market information system related to cement consumption,

For the government, recommendations for the Lao cement industry to be competitive are particular:

- To consider price mechanism for the Lao cement commodities in particular in order to ensure efficiency of the Lao cement industry.
- To promote establishment of quality control system in particular to adapt international quality standards.
- To provide better infrastructure to rural areas for all seasons.
- To strengthen macroeconomic stability.

7. Economic Integration of the Lao Economy: Case Study on the Lao Cement Industry

Introduction

Lao PDR officially became a member of the Association of South East Asian Nations (ASEAN) in 1997. One of the most important objectives of ASEAN is to create a free trade area, the so-called ASEAN Free Trade Area (AFTA). As a new member of ASEAN, Lao PDR has to implement the AFTA scheme completely by the year 2008. This means that, by the year 2008, all the items on the current Temporary Exclusion List (TEL) must be shifted to the Inclusion List (IL) with tariff rates of between 0% and 5%. As a result, there will be no protection for domestic production, particularly in the manufacturing and service sectors.

In this context, the Lao cement industry is of concern. The main question is how can the Lao cement industry survive under the AFTA scheme if there is no protection by the state.

Despite major efforts to develop the cement industry, there has been very limited study so far on the effects, in particular on competitiveness, in terms of import substitution and a clear future development program for the cement industry. The Lao government strongly stresses the importance of the construction material industry, especially the cement industry, as one of the subsectoral priority development programs within the framework of its industrialisation strategy.

In the sense of trade liberalisation, AFTA will create additional opportunities for Lao PDR in terms of access without barriers to the markets of the ASEAN member countries. However, trade liberalisation will also bring Lao PDR face-to-face with challenges as the Lao economy is not healthy enough to be able to compete with member countries in trading activities. Many sectors are still in the initial stage of development. In this context, the Lao cement industry seems to be one of the more sensitive domestic industries. The purpose of this study, therefore, is to examine how the Lao cement industry will be affected by implementation of the AFTA scheme.

In this sense, assessment of the impact of AFTA accession on the Lao cement industry has been taken into account in order to provide information to meet the need for future developmental planning of the Lao cement industry as an example for other domestic industries facing similar conditions.

The research was undertaken by the NERI research team under the Laos-Japan Intellectual Cooperation Project on Macroeconomic Policy Support, Phase II, Economic Integration Working Group. The Research Team includes Dr. Leeber LEEBOUAPAO, Deputy Director of the National Economic Research Institute, Mr. Thanongsai SOUKKHAMTHAT, Economic Researcher, and Mr. Sayasack SENGARLOUN, Research Assistant.

The report is divided into five parts.

The first part provides general background information related to the Lao cement industry under the AFTA scheme and Lao PDR's commitment under CEPT. It also provides an overview and short description of the Lao cement industry.

The second part focuses on the development of the cement industry in Lao PDR. It discusses the cement market situation, in particular, and also introduces new cement plants. The biggest plant is in the process of construction in the south of Lao PDR.

The third part discusses cement production, imported cement and domestic demand for cement.

The fourth part deals with the potential for development of the Lao cement industry, the constraints and disadvantages in competitiveness and the impact of AFTA/CEPT on the Lao cement industry.

In the final part, a conclusion will be drawn and recommendations made from the perspective of development of the domestic cement industry. Suggestions will be aimed at seeking ways to optimise the economic benefits of AFTA accession for the Lao cement industry as well as for Lao PDR

Methodology

The study involves a number of approaches including the following:

- **Literature survey:** Reviewing the existing documents.
- **Field survey:** Conducting a field survey by interviewing the directors and staff of Cement Plants I and II, cement sellers and consumers, and the ministries and authorities concerned. Methodologically, the interviewed authorities were selected based on the importance of the agencies dealing with them.
- **Analysis:** Major efforts are made to analyse the data and information gained from the survey.

Location of Field Survey

1) Vientiane Province: Vang Vieng, Phonhong, Thalath
2) Vientiane (Capital)
3) Khammoune Province
4) Savannakhet Province
5) Champasak Province
6) Saravanh Province

Enterprises:

1) Vangvieng Cement Plant I
2) Vangvieng Cement Plant II
3) Lao Import and Export Company
4) Asia Trading Company
5) Savannakhet Cement Plant Branch

Ministries and Provincial Divisions:

1) Ministry of Commerce
2) Ministry of Finance
3) Ministry of Industry and Handicrafts
4) Ministry of Communication, Transportation, Post and Construction
5) Ministry of Agriculture and Forestry
6) Commerce Division of Khammoune, Savannakhet, Champasak and Saravanh Provinces
7) Industry Division of Khammoune, Savannakhet, Champasak and Saravanh Provinces
8) Planning and Investment Division of Khammoune, Savannakhet, Champasak and Saravanh Provinces

Techniques used in the survey were:

- Small-group interviews of members of both the government and private sectors, such as general directors, directors, division chiefs, accountants, key informants, businessmen, specialists and so on.
- Collecting of existing published materials from national and international agencies.
- Direct observation by taking notes on matters, objects, activities and characteristics of the cement market environment.

The main objective of this study is to:

- Analyse the situation, constraints and problems of the Lao cement industry as well as its development potential and opportunities.
- Study the impact of AFTA accession on the Lao cement industry.
- Recommend strategies/policies for the development of a competitive Lao cement industry within the context of AFTA accession.

I. Lao PDR's Economic Integration

1. AFTA Scheme

The international challenge for Lao PDR is the outcome of the transition process of ASEAN (Association of South East Asian Nations) integration. ASEAN was established on 8 August 1967 in Bangkok. Lao PDR applied for ASEAN membership in March 1996 and became a member in July 1997 together with Myanmar. At the present time, there are 10 ASEAN member countries, namely Brunei, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Vietnam and Cambodia, which became an ASEAN member in 1999.

An historical milestone for Lao PDR was hosting the 10th ASEAN Summit on November 29-30, 2004 in the capital, Vientiane, which was attended by the heads of state and governments of ASEAN member countries and its dialogue partner countries, namely Australia, China, India, New Zealand, the Republic of Korea and Japan. This event afforded Lao PDR the opportunity to strengthen its standing and relations in the international community as well as promoting achievement of its goal to escape the position of least developed country by 2020. In addition, the cooperation of the dialogue partner countries helped Lao PDR to narrow the development gap among ASEAN countries through financial and technical assistance.

In order to develop the economy within the ASEAN member countries, they agreed to create an ASEAN Free Trade Area (AFTA) in 1992. The main objective of AFTA is to increase the international competitiveness of the ASEAN countries. Specifically, the objectives are to increase intra-ASEAN trade by reducing tariffs and non-tariff barriers while allowing member countries to keep their respective trade policies in the global market. AFTA aims to reduce tariffs on all manufactured and processed agricultural commodities traded within the ASEAN member countries to between 0% and 5% and completely remove all other trade restrictions by the year 2008 through the Common Effectiveness Preferential Tariff (CEPT) scheme which is the main instrument of AFTA. The agreement also lays down rules for fair trade and competition and sets out a number of measures to enhance economic cooperation and macroeconomic stability while attracting direct foreign investment.

Under the CEPT scheme, there are four lists, namely the Inclusion List (IL), Temporary Exclusion List (TEL), Sensitive List (SL) and General Exception List (GEL). These four instruments are used to define the pace and scope of trade liberalisation. The IL contains items immediately subject to tariff reductions to 0%-5% by the year 2003. Items in the IL category are eligible for preferential tariffs if they meet three conditions: (1) the item subject to tariffs must also be included in the IL of the importing and exporting member countries; (2) if the importing country's CEPT rate for the item is 20% or less, the exporting country's CEPT rate for the same item must also be 20% or less; (3) the importer must be able to demonstrate to the satisfaction of the Customs Department that the item is "original" in that the ASEAN content of the goods, defined in terms of the share of value added originating in the ASEAN countries, is at least 40%. The SL is the list of unprocessed and processed agricultural products to be transferred to IL between 2001 and 2003, the tariffs on which are to be reduced by the year 2010. The GEL contains items that are permanently excluded from tariff reductions for reasons of national security, protection of public morals, protection of human, animal and plant life and health, and protection of articles of artistic, historic and archaeological value.

2. Lao PDR's Commitment to AFTA

Under the AFTA scheme, all Lao commodities are categorised into the four lists, IL, SL, TEL and GEL, mentioned above. So far, Lao PDR has made progress in liberalising trade by increasing the number of lines in the IL list under CEPT. (See Table 1).

Table 1: 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, aluminium, 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	

Source: Lao authorities and WB staff calculations

As illustrated in Table 1, in 1997 Lao PDR started with 533 items in the Inclusion List (IL) with a tariff rate of 0%-5% and dramatically increased the number year by year. By 2004, the IL had increased to 2,967 items and Lao PDR is committed to having 98% of its lines at the tariff rate level of 0%-5% for ASEAN commodity imports by 2008. The Temporary Exclusion List (TEL) with a maximum tariff rate of about 20% has also been dramatically reduced and items moved to the IL year by year. Reduction of the tariff rate for all items in the TEL and transfer of items to the IL will be completed by 2008 after an adjustment period. Cement is one of the items in the TEL list. While other items in the Sensitive List (SL) were slowly reduced and the Government decided to effectively reduce the tariff rate to 0%-5% by 2015, it still had 75 items in the SL in 2004 including livestock, meat, freshwater, fish, vegetables, rice and lumber. Together with this, in the GEL, there are 74 items, of which 15 refer to beer, spirits, wine and other alcoholic beverages and 13 refer to vehicles.

II. Development Process of the Lao Cement Industry

Historically, Laos has relied heavily on cement imports for construction purposes. The concept of promoting domestic cement production for cement import substitution was initiated before the independence of Lao PDR in 1975. Efforts were made to construct two small cement plants in Thakhek district, Khammoune province, and in Vientiane province. However, the plan was not realised due to lack of funds and technical problems.

In the late 1960s a small cement plant, which became the trailblazer for the Lao cement industry, was established in Thakhek district, Khammoune province. However, the plant was not completed. Then, in 1973 a second cement plant, the Thong Pong Clinker Grinding Factory, was initially set up by the Lao 555 Company Ltd. It was located about 9 km north of the capital of Vientiane near Route 13. In 1981, the former Soviet Union provided technical assistance to Lao PDR to develop a cement factory with a capacity of 200,000 tons per year. Due to low productivity and high production costs, the factory could not be built even though the Soviet experts conducted a feasibility study on its establishment. In 1985, the Thong Pong Clinker Grinding Factory was built in the same place as the former site of the 555 Factory. It was named the "1st May Cement Factory" and was managed by the former Ministry of Construction. The factory produced type P-425 cement and had a production capacity of approximately 10,000 tons per year, but, in reality, practical production was only about 6,000 tons. However, the factory could not be operated because of the high cost of imported clinker, the inadequate support and distribution network and the high cost of production, and it was finally closed in 1994. However, in 1994 the first successful cement plant, located in Vang Vieng district in the north of Vientiane province, was established through the cooperation of the Lao and Chinese Governments. The Chinese government provided a loan to the Lao government with interest of 9% per year and non-disbursement for the first five years. The total cost of establishing the plant was about US$ 13 million and it was built by the Yunnan International Cooperation Company (Annual Financial Report, Vang Vieng Cement Plant, 1998). The cement plant was officially opened on 25th November 1994 and named the Vangvieng Cement Plant No. I. The plant was capable of producing 73,000 tons of cement per year and it produced two types of cement: Cement Portland P-525 and P-425 which used only domestic raw materials such as coal and limestone from Vangvieng and gypsum from Savannakhet province[1].

[1] Source: Report on the Impact of AFTA Accession on the Lao Economy, Vientiane 1999.

Picture 1: Vangvieng Cement Plant No. I

Photo: NERI

Due to the high demand for domestic cement, the Lao government considered building a second cement plant in 1998. It was completed in 2001 with a total investment capital of 300 million Yuan or about US$ 36 million and started production in March 2002 with a normal production capacity of 200,000 tons per year or 700 tons of clinker per day. However, it has been improved to a maximum production capacity of 244,000 tons a year. Both Cement Plants I and II produce cement by utilizing 100% domestic raw materials, in particular gypsum, loam, coal and pack bag. The new plant produces two types of cement, namely:

1) Portland Type I: American Standard: ASMT C –150
2) Portland Type II: Chinese Standard: GB 175-1999 (ISO 679)

This new cement plant is a joint venture company between the Lao PDR Agricultural and Forestry Development and Services Company, which owns Cement Plant I, with a share of 40%, and the Chinese state-owned enterprise, Yunnan International Economic-Technical Cooperation Company (YIETC), with a share of 60%, and is called the Lao Cement Co. Ltd. or Vang Vieng Cement Plant No. II. The Lao SOE share is a loan from the Chinese State Commercial Bank with an initial interest rate of 8%, but recently the Chinese government agreed to reduce it to 2.5%. The joint venture contract is effective for 29 years, starting from 1998. The total number of employees is 286, of which 33 are Chinese and 80% are local people from Vang Vieng district.

Picture 2: Vangvieng Cement Plant No. II

Photo: NERI

Recently, the Lao Agricultural and Forestry Development and Services Company (DAI) has cooperated with the Construction Material YUNNAN Company (China) on building a mill cement plant in Savannakhet province with a production capacity of 180,000 tons/year. Construction was completed and cement production started in early June 2004. The company can supply cement to Khammoune, Savannakhet and Champasak provinces and to the south of the country.

In early 2004, DAI cooperated with domestic and foreign investors to conduct a feasibility study on building a cement plant in Thakhek district with a production capacity of about 600,000 tons/year. There are four main investors in this cement company; the Vientiane Commercial Bank has the biggest investment at 50%, with the Kolao Developing Company at 20%, DAI at 15% and Mr. Sop SISOMPHOU holding an investment of 15%. The total registration capital in this cement plant is US$ 6 million[2].

[2] Source: Domestic Investment Licence, No. 009-04/FIMC.CPI. Dated: 18 August, 2004

III. Domestic Cement Production, Cement Imports and Domestic Demand for Cement

Cement Production by Vangvieng Cement Plants I and II

After building the second cement plant in 2002, domestic cement production increased about threefold, from approximately 80,000 tons in 2000 to 332,000 tons in 2003, of which 88,300 tons were produced by Cement Plant I and 244,000 tons were produced by Cement Plant II. This covers about 40% of the total cement demand of approximately 800,000-1,000,000 tons in Lao PDR (see Table 2). This means that the market share of Lao Cement Plants I and II is about 40%.

Because domestic cement production cannot cover the cement consumption needs of the country, Lao PDR currently imports cement, mainly from Thailand. About 80% of total cement imports in 2003 were from Thailand, while the rest was from Vietnam and China.

Table 2: Cement Production, Cement Imports and Cement Consumption in Lao PDR (in tons) (1995 -2003)

Year	Production in tons		(Commercial Cement Imports in tons)	(Total Consumption in tons)	Percentage Changes (in %)
	Plant No. I	Plant No. II			
1995	60,193	-	162,000	222,193	
1996	75,966	-	322,776	398,742	**79.46**
1997	82,016	-	329,136	411,152	**3.11**
1998	80,181	-	691,136	771,317	**87.60**
1999	61,301	-	207,330	268,631	**-65.17**
2000	82,079	-	244,307	326,386	**21.50**
2001	74,785	-	340,737	416,522	**27.62**
2002	78,292	151,432	350,000	579,724	**39.18**
2003	88,300	244,000	332,300	800,000	**38.00**

Source: Cement Plants I and II, Ministry of Commerce, NERI's calculations, 2004

Remark: Total cement consumption = Domestic cement production + commercial cement imports + cement procured with overseas aid

Both Vangvieng Cement Plants I and II can supply cement, in particular, to the markets in the capital Vientiane, in Vientiane, Bolikhamxay, Luangphabang and Xiengkhuang provinces and Xaysomboun Special Zone, but they can only supply lesser amounts to other provinces, especially Luangnamtha, Houaphanh, Khammoune and Savannakhet provinces, which have to import cement to meet their needs (see Table 3). Because of the great distance from the Vangvieng Cement Plants to other provinces and the resultant high transport costs, many provinces rely totally on cement imports, namely Bokeo, Phongsaly, Xaygnabouly, Champasak, Saravanh, Sekong and Attapeu provinces.

Table 3: Cement Supply to Provinces in Lao PDR, 2003

No	Provinces	Type (Tons)		Total (Tons)
		(Bag)	(Bulk)	
1	Vientiane (Capital)	147,000	30,000	177,000
2	Bolikhamxay	6,000	-	6,000
3	Khammoune	15,000	1,000	16,000
4	Savannakhet	40,000	-	40,000
5	Vientiane	23,000	-	23,000
6	Luangphabang	6,000	3,000	9,000
7	Xiengkhouang	7,000	-	7,000
8	Oudomxay	5,000	-	5,000
9	Luangnamtha	5,000	-	5,000
10	Houaphanh	1,000	-	1,000
11	Xaysomboun	2,000	-	2,000
12	Xaygnabouly	1,000	-	1,000
13	Other projects	13,000	-	13,000
	Total	144,000	34,000	278,000

Sources: Cement Plants I & II, 2004

New Cement Industry in Southern Lao PDR

In the middle of 2004, the third Lao cement factory was built in Savannakhet, with a production capacity of 180,000 tons a year. In Saravanh and Khammoune, there are also plans to build cement plants with a production capacity of 300,000 tons and 600,000 tons per year respectively. Construction of the cement plant in Saravanh province will be completed at the end of 2006 and production will start in early 2007, while in Khammoune province construction will be completed at the end of 2005.

Estimation of Domestic Cement Production by 2007

By early 2007, the total cement production of Vangvieng Cement Plants I and II and the cement plants in the southern part of the country will increase current production more than fourfold to approximately 1,400,000 tons a year, sufficient to cover domestic demand for cement. In the medium term, the trend in domestic cement demand will increase significantly as a result of GDP growth, in particular the increase in income of the Lao population, which will lead to an increase in demand for cement for private construction purposes as well as increasing the need for cement for government infrastructure development projects.

IV. Factors Indicating the Competitiveness of the Lao Cement Industry

1. Comparative Advantages

1.1. Raw Material Resources

Both Cement Plants I and II in Vang Vieng are located directly beside very large limestone deposits. They are also rich in other material resources, especially clay, silica, gypsum and coal that are available close by.

In Saravanh province there are abundant raw material supplies for cement production. In particular, it has a coal source of approximately 2,277,000 tons at a depth of more than 100m. In addition, it has a huge source of limestone of more than 6.2 million tons. Furthermore, clay is also available and is close to gypsum which is available in Savannakhet province.

As for the cement plant in Savannakhet province which has just recently started production and trial supply for consumption within Savannakhet province, it still imports clinker from Thailand. After the completion of the cement factory in Khammoune province, it will use the clinker from this factory and stop importing it from Thailand. This will reduce the cost of production as well as reduce the price of cement within the country.

1.2. Power

The cement plants in Vang Vieng use hydropower from the Namgum Dam, giving them a comparative advantage in terms of electric power costs. This will contribute to the total cost advantage of cement production.

1.3. Location

Both Cement Plants I and II are located in the middle of the country. They can expand their market to the south and to the north of the country. In the long run, due to the location of Lao PDR in the centre of the Southeast Asian region and as it shares borders with four ASEAN member countries, Vietnam, Cambodia, Thailand and Myanmar, in the near future, after implementing GMS programs, the plants will have the opportunity to expand their market to neighbouring countries. In addition, the new cement plant in Savannakhet province is located in the middle of Lao PDR and is situated on the East-West Economic Corridor and Route 9. This condition is a factor supporting the cement industry within the country and may lead to access to regional markets.

1.4. Quality of Cement

The cement produced at Vangvieng Cement Plant II is certified as complying with international standards. This means that cement from Vangvieng Cement Plant II can compete with Thai cement in terms of quality.

2. Constraints and Disadvantages in Competitiveness

The findings of the study show the following concerns regarding constraints and disadvantages:

1) The price of Lao cement is determined by the state and cannot be flexed to market mechanisms when faced with a rise in the inflation rate, and there is a need for a huge amount of foreign currency for import of spare parts and technology and interest payments.

2) High transport costs leading to high prices

Inadequate infrastructure development in the country and the long distance from the cement plants to the destinations make the transportation cost of cement products very high. In Lao PDR there is no railway and transporting cement goods by trucks is relatively inefficient and expensive. Therefore, cement products from the Vangvieng Cement Plants cannot gain an advantage in all domestic markets. Currently, the price of Lao cement compared with Thai cement can only be competitive for destinations no more than 300 km from Vangvieng Cement Plants I and II.

3) High production costs

Electrical costs account for a high share of production costs at about $5.8/ton.

To sell cement in kip, but to pay interest and loans in US$ will impact turnover and profits while the exchange rate is unstable.

The investment capital for construction of both cement factories is a 100% loan in foreign currency with a relatively high interest rate. The enterprises must bear a heavy debt burden, which leads to high costs.

Spare parts, materials and instruments used for heavy machines, machine fuel and soil bombs must be imported and paid for in US$. However, exchange rates are often unstable. This often causes high costs in domestic currency while prices of domestic cement commodities are fixed.

Consequently, Lao cement cannot compete with Thai cement even in the capital, Vientiane, in terms of cheaper price if the tax on imported cement from Thailand is reduced to 0%. Currently, the price of Thai cement in the capital is about 680,000 kip/ton, including import tax of 10%. If there is no import tax, the price of Thai cement per ton in Vientiane will be about 612,000 kip/ton compared with 640,000 kip/ton for Lao cement sold in Vientiane.

4) Limited weight loading

The permitted weight for a container and goods is only 40.5 tons compared with Thailand where it is 47 tons. A trailer, 10-tyre truck and 6-tyre truck can load 22 tons, 12 tons and 8 tons respectively.

5) The quality of the cement from Plant No. I did not reach international standards. This means that it cannot compete with Thai cement in terms of quality.

6) Lao cement plants are small in scale and lack economy of scale compared with Thai cement plants which are large in scale and have a production capacity of more than 1 million tons per year, and they have their own investment capital without having to make loan arrangements with another country.

7) The current coal resources used for cement production at both plants are limited and will be sufficient only until 2006. Thus, new coal deposits need to be studied and exploited. This will require huge capital.

8) Fall in price of cement on ASEAN markets

There has been a trend towards falling cement prices on ASEAN markets since 1994. The main causes are:

- The rapid development of the cement industry in Thailand has succeeded in minimising costs by developing high-tech production factors and a well-functioning management system.
- Cost minimising through infrastructure improvement, especially the transport system between Laos and Thailand after the opening of the Lao-Thai Friendship Bridge between Vientiane and Nongkhai in April 1994, is a significant factor.
- Competition has intensified among cement producers in the region.
- There is a cement surplus which will lead to cheaper cement prices and consequently to fiercer competition among manufacturers.

3. Impact of AFTA/CEPT on the Lao Cement Industry

Table 4 below illustrates that in terms of prices, if import tariffs on imported cement are reduced to 0%, the price of Lao cement can compete with Thai cement in the capital Vientiane, but not in the south of Lao PDR. The price of type P-525 Red cement from the new cement plant in Savannakhet is 700,000 kip/ton, which is more expensive than the cement produced by the Vangvieng Cement Plant (608,000 kip/ton).

Table 4: Price of Cement under AFTA/CEPT Scheme by 2008 and 2015

Exchange rate: 10,436 kip/$ (9 December, 2004)

No.	Type of Cement	Current Price of Imported Cement from Thailand (including 10% tariff) (2004)	Price of Imported Cement from Thailand (with 5% tariff) By 2008	Price of Imported Cement (with 0% tariff) By 2015	Price of Domestic Cement
		(kip/ton)	(kip/ton)	(kip/ton)	(kip/ton)
Vientiane Capital	- P425 Blue				574,000
	- P 525 Red				608,000
	- P4.25 Golden				584,000
	- ASPM				618,000
	- Tiger (Thai)	710,000	674,500	639,000	
Savannakhet Province	- P425 Blue				687,000
	- P525 Red				700,000
	- Elephant (Thai)	764,000	725,800	687,600	
	- Tiger (Thai)	720,000	684,000	648,000	
	- Red TPI (Thai)	760,000	722,000	684,000	
	- Green TPI (Thai)	720,000	684,000	648,000	
Khammoune Province	- Elephant (Thai)	678,340	644,423	610,000	
	- Diamond (Thai)	626,160	594,852	563,544	
	- Tiger (Thai)	594,852	565,109	535,367	
	- Eagle (Thai)	553,108	525,453	497,797	
	- TPI (Thai)	521,800	495,710	496,620	
Champasak Province	- Cement	481,520	457,444	433,368	

Source: Commercial Division of Savannakhet, Champasak and Khammoune Provinces

V. Conclusion and Recommendations

1. Conclusion

1. The domestic cement industry's market share in the country is relatively small, but will increase more than fourfold by early 2007 after completion of the ongoing cement plant construction in Khammoune and Saravanh provinces.

2. At present, the Lao cement industry can supply cement commodities with the largest market share to domestic markets, in particular those close to Vangvieng Cement Plants I and II, but in many provinces, they still need to import cement from neighbouring countries.

3. The trend in market demand for cement, in particular for public infrastructure as well as for business and household consumption, in Lao PDR is growing rapidly. This will offer market

opportunities for the Lao cement industry. However, under the AFTA/CEPT scheme, the Lao cement industry will face cheaper imported cement through tariff reductions to 0% after 2008.

4. In terms of price competition, if import tariffs on imported cement are reduced to 0%, Lao cement commodities can compete with Thai cement in the capital of Vientiane, but not in the south 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.

5. In terms of quality, the cement produced by Cement Plant No. II is accepted as comparative with international standards, i.e. it has competitive quality. However, the cement produced by Cement Plant No. I falls below international standards.

6. In terms of comparative advantages, the Lao cement industry has potential in terms of material resources and labour costs, while having disadvantages in terms of high transportation costs, high cost of technology, spare parts and equipment, inflation, unstable exchange rate, debt burden, etc.

7. The expected benefit from AFTA/CEPT for the Lao cement industry is cheaper import of input factors (raw materials, spare parts, vehicles, etc.)

8. After 2008, by fully implementing the commitment of Lao PDR to AFTA/CEPT, assuming that the current price of domestic cement commodities, in particular cement supplied to markets far from the Vangvieng Cement Plants, the price of cement produced in the south and the current quality of cement produced at Vangvieng Cement Plant I remain the same, it will not be possible to compete with imported cement from Thailand.

2. Recommendations

Lao cement producers should prepare measures for integration in order to adjust to their competitors or at least to survive. In particular, they should:

- improve the capacity of cement production, and especially improve the quality of cement products and minimise production costs by reducing unnecessary costs, with the aim of reducing the selling price and promoting competitiveness. Together with this, they should also improve the management, organisation and productivity of cement production,
- upgrade and train workers and staff of the Lao cement industry in accordance with the need for modern production, management and marketing,
- study the comparative advantages of their competitors in neighbouring countries,
- look for new markets in the country, but also in neighbouring countries,

- establish a research and development division for cement production and marketing,
- develop a market information system related to cement consumption.

For the government, recommendations to make the Lao cement industry competitive are, in particular:

- To consider a price mechanism for Lao cement commodities in order to ensure the efficiency of the Lao cement industry.
- To promote the establishment of a quality control system in order to adapt to international quality standards.
- To provide a better infrastructure to rural areas in all seasons.
- To strengthen macroeconomic stability.

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8. Competitiveness of Some Selected Lao Commodities in the Light of Regional Integration and WTO Accession.

Sirisamphanh VORACHITH

Summary

The economic integration of the Lao PDR into the regional and world trading arrangements is considered to be a way to increase its international trade volume. Negotiations for market access in itself do not guarantee a better export performance of the Lao firms unless Lao exporters are competitive in international markets. What to do next in order to improve competitiveness remains to be seen. In the world market, Laos has to compete not only with LDCs, but also with other developing and developed countries, depending on the products.

The future economic growth of this country will have to rely on its export potentials and performance. Export-led growth implicitly entails economic integration with the sub-regional, regional and world trading arrangements. Without integration, market access and foreign direct investment (FDI) are not possible. FDI tends to flow to countries where there is a lower risk with higher return, where competition and a conducive business environment prevail. FDI is not only important to the inflow of foreign capital, but should be treated as an opportunity for technology, labor skill and management skill transfer for the country, and a way to penetrate foreign markets and develop Lao products. This is particularly true in the case of the Lao PDR given its geopolitical location and its small market size.

The present situation of Lao PDR's exports truly reflects its natural resource endowments. Lao PDR has a vast potential in hydroelectricity, which already constitutes a substantial part of its foreign exchange earning. Mining, and the recent exploitation of gold, is an emerging growth potential. The garment industry has expanded in the last decade and is now facing fierce competition since China joined the WTO. The competition from 2005 onwards, after the phasing out of the quota of textile and clothing under the Multi-Fiber Agreement among WTO members, will become more serious.

The International Trade Center has identified 13 sectors of leading export performance of Least Developed Countries, out of which 11 are commodities and two are services sub-sectors. Lao PDR shares most of these products. For this particular purpose, the research will focus on the export of goods and particularly the agricultural and forestry sectors. The reason for choosing these sectors is to attempt to address the major problem of commodities production in the Lao PDR. This is a very hot issue currently under consideration by the government. We are now confronting issues with our production capacity, or the so-called supply-side constraints.

Overview of the SWOT Analysis of the productive capacity of the Lao PDR

Opportunities

The contemporary trading world is characterized by an increasing trend in the establishment of bilateral, sub-regional, regional free trade arrangements and the rule-based multilateral trading system. The usual gains from trade will very much depend on to what extent the country is integrated into these trading arrangements. Lao PDR currently is granted preferential market access to most of the developed countries and some of the developing countries, including a few of the founding members of ASEAN, under the ASEAN Integration System of Preference. It has substantially reaped the benefits of this **GSP (Generalized System of Preferences)** in the development of the garment industry, which is mainly foreign owned. Garment production is mostly aimed for export to the European Union and to a wide range of countries, though to a lesser degree. At the same time, preferential market access for many other products is not taken advantage of due to constraints in supply. This will be addressed later in the paper.

There are demands in the international market, especially the niche market, for products from the Least Developed Countries. Market and investment opportunities abound in this part of the world if one really explores the hidden potentials. The best known features are abundant natural resources and low labor costs.

Threats

The international market environment is constantly changing and very demanding. The success of an economy in this globalized world does not necessary lie in the fact that the national economy is exposed to external market forces. Unless it is well managed, trade liberalization can result in the reduction of fiscal revenues. It can also result in the vulnerability and inability of local producers and business practitioners to cope with the sudden change in the competitive trading environment.

Strengths and weaknesses of local products versus foreign competition

The actual situation of agricultural and industrial production in the Lao PDR can be briefly described as follows:

The main sectors contributing to the GDP as of fiscal year 2002-2003 are agriculture and forestry with a 49.2% share, industry 25.1% and services 25.7%. The expansion of domestic and foreign trade has had a positive impact on GDP growth and poverty reduction. GDP growth in the same fiscal year reached 5.9%.

Agriculture as a sector is composed of four main sub-sectors, namely plant cultivation, animal husbandry, fisheries and forestry. Agriculture, the leading sector in terms of GDP composition, constitutes only about 30% of the value of exports, mostly through coffee and wood production. This is explained by the fact that 83% of Lao PDR's population live in rural areas, out of which 66% rely on subsistence agriculture. The production of commodities is therefore carried out on a small scale through farming practiced by people who produce and sell goods and in many areas individually without coordination.

Lao PDR's principal crops are rice, cotton, tobacco, vegetables and maize. Rice cultivation forms the main economic activity since it constitutes 20% of annual GDP and 39% of agricultural GDP. The principal natural resources are timber from the vast forested areas of the south.

Besides hydroelectric power, which is the top export item, the country also has large deposits of minerals; particularly iron ore, limestone, tin and gypsum, which have been untapped so far. Only gold, tin ores, gypsum and lignite are exploited on a large scale. Cottage industries include salt extraction, weaving, rice mills, pig and poultry farms, brick and ceramic kilns and repair shops. Industrial plants in operation include agro-processing (beer brewery, animal feed mill), wood processing firms (sawmills exporting furniture products and other types of wood products), construction and manufacturing companies (assembly operations and construction material producers such as cement and steel bar) and garment factories.

Foreign trade performance of the Lao PDR

Imports have grown at an average rate of 2.6 % per annum over the last five years. Imported goods reflect the state of domestic production and range from fuels and lubricants, vehicles, spare parts, machinery, equipment, and construction materials to consumer goods, office supplies, textile and clothing, raw materials, agricultural inputs, foodstuffs and others.

The average annual export growth over the same period reached 6.8 %. Export items are more or less resource or market-based and include hydroelectricity, garments (mostly exported to the EU on a GSP basis), timber and wood products, coffee and a few agricultural products, non-timber forest products, and others. The sudden increase in the export of minerals is attributed to the mining of gold and copper ores.

Given the geographical position of the country, re-export and transit trade, which reached an amount of US $145,475,918 in fiscal year 2002-03 also play an important role. However, this figure has recently shown a declining trend mainly because of alternative transit routes in neighboring countries.

Overview of constraints of the productive capacity

The usual approach to production bottlenecks is to solve problems relating to production factors, such as land, capital, labor, technology and management skills.

Land issue: Lao PDR has a relatively large land area compared to its population. The land area, fertility, and natural climatic conditions are particularly important for agricultural and forestry production. Two-thirds of the country's land area is mountainous and mostly covered by forest. However, the forest area has decreased as a result of shifting cultivation practices, dam construction and wood exploitation.

Foreign investors can lease land for business purpose, whereas land ownership by foreigners is not permitted by law. Land in most areas in Lao PDR has not been prepared physically for large-scale plantation or cultivation. The parceling out of land and forest in some rural areas has solved the lack of necessary plot for deprived farmers. Many cases of non-acquisition of sufficiently large areas for agricultural commodities production have been cited, despite the legislation that land is owned by the state, but the people tend to possess individual plots thus pursuing different purpose of land use, preventing a large coverage of land area for an industrial undertaking.

Capital: The country needs a huge amount of capital to develop its production capacity. Capital is not only important for its own sake, but for the acquisition of machinery and technology. Labor can also be secured from external sources if there is sufficient capital. Unless capital is made available to local producers, there is little chance to modernize the existing production facilities. Capital as initial investment is important, but working capital is equally important for most business undertakings. For the time being, a capital-intensive industry is not feasible. Generally speaking, capital as a source of finance for local agricultural or industrial production is lacking.

Labor: Even though agriculture employs the vast majority of the labor force, it is seasonal work. The garment industry is a good example of a labor-intensive industry that has helped relieve the problem of unemployment, as it continues to acquire more laborers each year. Labor-intensive industry might not be sustainable in the long run, since emerging industries will absorb most of the labor force from agriculture. Because the country does not have abundant labor compared to most neighboring countries, there will be an unavoidable rise in labor costs which will reduce Lao PDR's competitive advantage. Labor as a production factor should be understood in terms of quantity, quality or skills, discipline and cost.

Technology: The level of technology used in this country relies, to a great extent, on the level of education of the population, the skills of laborers, management, and the availability of capital. There is a natural tendency to adopt relatively modern technology. In agriculture, draught animals are substituted by hand tractors and other agricultural machinery and tools. Much remains to be done in this area. Agricultural extension services should be enhanced and more efficient production methods and techniques should be introduced around the country.

Management: The concept of entrepreneurship should be discussed along with management skills. In a market-oriented economy, the economic operators who actually supply goods to society, are producers and marketing intermediaries. Therefore, in order to develop the production of commodities, a great number of entrepreneurs are required. Entrepreneurs are the investors who are willing to take risks and seek profits in their day-to-day production and marketing activities.

In this country, people wonder why there is a lack of well-paid jobs. This question is closely related to job creation in the economy. While most of us are trained to become salaried workers, there is no doubt that entrepreneurial initiatives are lacking. At the initial stage, entrepreneurs tend to develop a family business. When the business grows, there is a need for a more professional manager, which can be separated from the ownership of the business. The internal and external environment of the firm itself requires increased managerial skills of its executives. This human component is a determining factor in mobilizing and exploiting the natural resources, and the available capital and labor force.

Marketing concept issues: Producers, especially in the agricultural sector, are more production or product-oriented, which means that they tend to produce first and then make efforts to sell. They care more about their production or products than the needs of the market. The reason for this might be that production has not yet reached the stage where oversupply or overcapacity can create a drastic price drop. In other words, since they manage to sell whatever they produce, why should they improve their product quality? Likewise, producers tend to wait for a guaranteed market before they all engage in the production of a given commodity. This also applies to some exported commodities.

To my understanding, market demands must be analyzed in detail before production decisions can be undertaken. Of course, without production, selling efforts can hardly be envisaged. The usual evolution is that domestic production develops itself through production for the internal market. Producers learn and master the process of supply for the domestic market on a regular basis, meeting all quality standards, sufficient quantity, and offering a competitive selling price. In doing so, the producers gather experience over time, which will prepare them for exporting. In this way, the grouping of small-scale producers is essential in order to implement the concept of contract farming. This practice will ensure that production is market-oriented and functions under a certain contractual framework regarding the supply of production. This practice will also help reduce risk.

Factors influencing the competitiveness of a given product: This general description can be examined at three different levels. At the macro level, the national economic stability and growth is an important factor to enhance domestic production.

A legal framework that is conducive to economic development, and to domestic and foreign direct investment and trade, is equally crucial in order to foster a sufficient number of successful exporters. Problems here exist in land leasing and ownership, financial incentives, in granting investment licenses, in the registration of businesses, and in the import and export procedure. These features cannot be improved unless a comparative study of the investment policies and legislation of neighboring countries is undertaken.

At the sectoral level, issues like labor, transit transport via third countries, and also domestic transport costs, capital cost and credit access are among cost burdens for most companies and affect their competitiveness. At this level, closer attention should also be paid to production costs. Fuel cost is competitive at least with Thailand and Vietnam, whereas electricity costs are not as cheap as in the country exporting it. Despite the fact that the government has invested substantially in infrastructure building, the costs related to the utilization of these facilities are not competitive because of different levels of government support of each country. Richer countries tend to subsidize their agriculture to such an extent that production does not operate according to market forces. This intervention has a trade distorting effect.

The general assumption is that the main constraint to the extension of production is market access. To many people's surprise, even one small problem can impede the whole production process. On the contrary, for a successful production undertaking, there needs to be a much more comprehensive approach on a continual basis, where all factors play a part.

At the company level, issues concerning finance, marketing, production, personnel and general management must be strengthened in order to create a capable exporter. Our exporters are mostly small and medium size enterprises with limited knowledge of foreign markets. In this regard, marketing strategies such as product planning, export pricing, distribution channels and marketing promotion should also be considered. In the product planning, product design, grading and standardization of a product, packaging and branding are key elements in competition. Other elements are also important to make export price competitive. The contract farming mentioned earlier will act as a guarantee for a stable price and market outlet or distribution channel.

Policy recommendations

To strengthen the production capacity and competitiveness of local firms, the government should seriously consider the following factors:

1. Pursue its investment in infrastructure with the goal to reduce production costs.
2. Technical support must be provided by relevant government agencies at minimum cost.
3. Human resource development should be another top priority.
4. Trade negotiations within bilateral and regional trading arrangements should be conducted in order to solve tariff and non-tariff trade barriers.
5. Legal framework should be strengthened in order to ensure law enforcement, and to create a pro-business investment climate in this country.

6. Sectoral issues should be dealt with by various government agencies with the goal to assist the business community in their productive and trading endeavors.
7. The issue of labor productivity should be seriously analyzed, since only skilled labor with modern technology can efficiently and effectively exploit the country's natural resources.
8. Market reform should be pursued and market imperfections should be addressed by the government. Entrepreneurship and managerial skills should be promoted among commodities producers and in the business community.

8. Competitiveness of Some Selected Lao Commodities in the Light of Regional Integration and WTO Accession.

Introduction

The economic integration of the Lao PDR into the regional and world trading arrangements is considered to be a way to increase its international trade volume. Negotiations for market access in itself do not guarantee a better export performance of the Lao firms unless Lao exporters are competitive in international markets. What to do next in order to improve competitiveness remains to be seen. In the world market, Laos has to compete not only with LDCs, but also with other developing and developed countries, depending on the products.

The government of the Lao PDR's strategic goals are to reduce this country's poverty by half in the year 2005, and eradicate it by 2010, thereby graduating from the group of Least Developed Countries by the year 2020. Bearing in mind the low stage of its economic development due to the country's low savings and low investment and with the aim to achieve the aforementioned targets, the future economic growth of this country will depend on its export potentials and performance.

Export-led growth implicitly entails economic integration with the sub-regional, regional and world trading arrangements. Without integration, market access and foreign direct investment (FDI) are not possible. FDI tends to flow to countries where there is a lower risk with higher return, where competition and a conducive business environment prevail. FDI is not only important to the inflow of foreign capital, but should be treated as an opportunity for technology, labor skill and management skill transfer for the country, and a way to penetrate foreign markets and develop Lao products. This is particularly true in the case of the Lao PDR given its geopolitical location and its small market size.

The present situation of Lao PDR's exports truly reflects its natural resource endowments. Lao PDR has a vast potential in hydroelectricity, which already constitutes a substantial part of its foreign exchange earning. Mining, and the recent exploitation of gold, is an emerging growth potential. The garment industry has expanded in the last decade and is now facing fierce competition since China joined the WTO. The competition from 2005 onwards, after the phasing out of the quota of textile and clothing under the Multi-Fiber Agreement among WTO members, will become more serious for a country like ours.

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Opportunities

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The international market environment is constantly changing and very demanding. The success of an economy in this globalized world does not necessary lie in the fact that the national economy is exposed to external market forces. Unless it is well managed, trade liberalization can result in the reduction of fiscal revenues. It can also result in the vulnerability and inability of local producers and business practitioners to cope with the sudden change in the competitive trading environment.

Strengths and Weaknesses of Local Products

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In a market-oriented economy, in order to ensure the viability of production, a number of conditions must be met. In the Lao PDR, production decisions are carried out by small-scale producers and business practitioners under the market forces. The market mechanism has not been fully activated to stimulate local production. The composition of our economic structure as laid out by the government is to develop the agricultural and forestry sector in order to develop the processing industry and the relevant supporting services sectors.

Foreign trade performance of the Lao PDR

Foreign trade plays an important role in the Lao economy, since the country cannot produce most of its goods. Recorded trade seems to be underestimated due to informal trade across the border. Trade statistics in fiscal year 2002-2003 show that imports amounted to US $551,119,387 and exports reached US $352,624,287. The Lao PDR has always had a trade deficit. Commodities traded in the last five fiscal years are shown in the following tables.

Table 1: Lao PDR imports in fiscal years 1998-2003 in US$

		1	2	3	4	5
N.	**Major imported items**	1998/99	1999/2000	2000/2001	2001/2002	2002/2003
1	Agricultural tools and inputs	22,562,000	25,000,000	18,066,577	8,801,632	16,819,120
2	Office supplies & sports equipment	6,392,200	6,827,000	2,027,131	4,423,992	3,959,489
3	Foodstuffs	35,948,015	19,744,000	16,919,515	16,339,630	22,692,166
4	Apparel & other consumer goods	48,875,000	17,430,340	10,432,795	13,254,406	13,523,229
5	Electrical appliances	61,022,841	7,200,000	2,794,732	3,223,917	3,690,201
6	Construction materials	86,007,257	30,831,000	29,894,211	28,090,341	21,357,510
7	Fuel and gas	69,534,974	77,190,000	98,831,196	79,605,822	107,000,000
8	Pharmaceutical products	32,868,165	3,480,000	4,200,657	2,679,247	1,845,718
9	Vehicles and spare parts	111,560,000	21,210,000	19,334,063	18,678,147	28,542,193
10	Luxury goods	6,722,632	3,100,000	741,540	1,534,235	4,163,545
11	Electricity	15,549,442	8,000,000	4,108,656	6,788,270	7,552,440
12	Garment raw materials		86,900,000	80,173,33	73,685,033	55,596,961
13	Informal Trade		45,000,000	76,404,240	80,224,452	21,338,065
14	Other raw materials					43,036,907
15	Other products		4,649,000	18,092,553	14,099,427	12,000,000
	Sub - total		356,561,340	382,021,199	351,428,553	296,952,469
16	Capital goods under FDI, ODA & loan projects		184,000,000	146,250,000	182,154,549	191,017,517
	Total Imports of Lao PDR	497,042,526	540,561,340	528,271,199	533,583,102	551,119,387

Table 2: Exports of Lao PDR in fiscal years 1998-2003 in US $

		1	2	3	4	5
N.	**Major exported items**	1998/99	1999/2000	2000/2001	2001/2002	2002/2003
1	Timber and wood products	62,271,712	71,270,000	80,193,611	77,799,706	69,950,205
2	Coffee beans	31,164,000	29,030,000	15,303,833	9,773,938	10,915,964
3	Gypsum, tin and gold ores	767,000	5,993,248	4,890,667	3,903,928	46,502,906
4	Non-timber forest products	2,548,709	4,163,165	6,617,544	8,223,654	5,722,816
5	Other agricultural products	11,234,100	5,092,457	5,706,247	7,661,796	11,123,119
6	Handicraft products	3,008,000	5,100,199	3,850,480	2,736,431	12,492,600
7	Garment products	80,500,000	94,370,000	100,139,447	99,937,863	87,115,268
8	Electricity	57,102,000	107,000,000	91,312,939	92,694,000	97,360,000
9	Other industrial products & miscellaneous	22,464,155	1,955,533	16,871,067	19,887,444	11,441,409
	Total:	271,059,676	323,974,602	324,885,835	322,618,759	352,624,287

Source: Ministry of Commerce of the Lao PDR (MOC).

Before interpreting the statistics, one should bear in mind the inconsistencies in data collection over the years. For example, “Capital Goods” in 1998-99 were not shown as such, but were allocated according to their product categories. In the years that followed, the MOC found it useful to separate this item. “Other raw materials” is shown separately in 2002-03 for the purpose of monitoring the expansion of domestic production, whereas in the previous year, this item might have been spread over a few items such as items 5, 6 and 8 of Table 1. The estimated “Informal Trade” figure is provided in order to compensate for errors and omissions, since in the previous years, trade statistics in Lao PDR were gathered mainly from import and export licenses. However, at present, import and export licensing requirements have been phased out for a number of items. Over the last five years, local production has expanded especially in building materials and pharmaceutical products.

Imports have grown at an average rate of 2.6 % per annum over the last five years. Imported goods reflect the state of domestic production and range from fuels and lubricants, vehicles, spare parts, machinery, equipment, and construction materials to consumer goods, office supplies, textile and clothing, raw materials, agricultural inputs, foodstuffs and others.

The average annual export growth over the same period reached 6.8 %. Export items are more or less resource or market-based and include hydroelectricity, garments (mostly exported to the EU on a GSP basis), timber and wood products, coffee and a few agricultural products, non-timber forest products, and others. The sudden increase in the export of minerals is attributed to the mining of gold and copper ores.

Given the geographical position of the country, re-export and transit trade, which reached an amount of US $145,475,918 in fiscal year 2002-03 also play an important role. However, this figure has recently shown a declining trend mainly because of alternative transit routes in neighboring countries.

Overview of constraints of productive capacity

The usual approach to production bottlenecks is to solve problems relating to production factors, such as land, capital, labor, technology and management skills.

Land issue

Lao PDR has a relatively large land area compared to its population. The land area, fertility, and natural climatic conditions are particularly important for agricultural and forestry production. Two-thirds of the country’s land area is mountainous and mostly covered by forest. However, the forest area has decreased as a result of shifting cultivation practices, dam construction and wood exploitation.

Foreign investors can lease land for business purposes, but they are not allowed to own land. Land in most areas in Lao PDR has not been prepared for large-scale plantation or cultivation. The allocation of land and forest in some rural areas has solved the problem of a lack of necessary plots for deprived farmers. Although land is owned by the state, there are many instances where large areas of land have not been used for agricultural production. Rather, people tend to possess individual plots and pursue different uses for their land. As a result, large areas of land have not been used for industrial purposes, unlike the Paksap sugar mill in the suburbs of Vientiane. The concept of industrial land has been discussed, and the government has realized the importance of land as a valuable asset to exploit. However, if not properly regulated, land can be a cost burden for most business entities. For this purpose, the government has decided to set up the National Agency for Land Management under the Prime Minister's Office.

Capital

Realizing the need for capital in production, the government passed the first law on the promotion of foreign investment in 1988. Since then, there has been a large amount of FDI in the country which has contributed to its socio-economic development. However, this trend slowed down after the Asian financial crisis and has still not recovered, and a new wave of FDI has begun flowing into promising areas such as China and Vietnam. As far as domestic investment is concerned, it is limited purely by low domestic saving.

The country needs a huge amount of capital to develop its production capacity. Capital is not only important for its own sake, but for the acquisition of machinery and technology. Labor can also be secured from external sources if there is sufficient capital. Unless capital is made available to local producers, there is little chance to modernize the existing production facilities. Capital as initial investment is important, but working capital is equally important for most business undertakings. For the time being, a capital-intensive industry is not feasible. Generally speaking, capital as a source of finance for local agricultural or industrial production is lacking. In addition, financial management needs to be improved in many business entities, including state-owned enterprises.

Labor

The labor force in the Lao PDR represented about 38% of the total population in 2002. Even though agriculture employs the vast majority of the labor force, because it is seasonal work, workers must search for secondary jobs in other sectors in the cities. Some even look for better-paid work, temporarily and illegally, in Thailand. The garment industry is a good example of a labor-intensive industry that has helped relieve the problem of unemployment, as it continues to acquire more laborers each year. In the first phase of this MAPS project, Professor Ohno, the team leader of the industrial policy working group, revealed that labor-intensive industry might not be sustainable in the long run, since emerging industries will absorb most of the labor force from agriculture. Because the country does not have abundant labor compared to most neighboring countries, there will be an unavoidable rise in labor costs which will reduce Lao PDR's competitive advantage. Labor as a production factor should be understood in terms of quantity, quality or skills, discipline and cost.

Technology

The level of technology used in this country relies, to a great extent, on the level of education of the population, the skills of laborers, management, and the availability of capital. There is a natural tendency to adopt relatively modern technology. In agriculture, draught animals are substituted by hand tractors and other agricultural machinery and tools. Much remains to be done in this area. Agricultural extension services should be enhanced and more efficient production methods and techniques should be introduced around the country. Furthermore, intensive and extensive agricultural development should be practiced concurrently or alternatively where appropriate. Organic farming is another way to develop traditional agriculture.

Management

For the purpose of this study, entrepreneurship should be discussed along with management skills. In a market-oriented economy, the economic operators who actually supply goods to society, are producers and marketing intermediaries. Therefore, in order to develop the production of commodities, a great number of entrepreneurs is required. Entrepreneurs are the investors who are willing to take risks and seek profits in their day-to-day production and marketing activities.

In this country, people wonder why there is a lack of well-paid jobs. This question is closely related to job creation in the economy. While most of us are trained to become salaried workers, there is no doubt that entrepreneurial initiatives are lacking. At the initial stage, entrepreneurs tend to develop a family business. When the business grows, there is a need for a more professional manager, which can be separated from the ownership of the business. The internal and external environment of the firm itself requires increased managerial skills of its executives. This human component is a determining factor in mobilizing and exploiting the natural resources, and the available capital and labor force. At the least, an entrepreneurial or managerial mind is crucial to problem solving, especially when not all the resources are available in given place.

Marketing concept issues

Producers, especially in the agricultural sector, are more production or product-oriented, which means that they tend to produce first and then make efforts to sell. They care more about their production or products than the needs of the market. The reason for this might be that production has not yet reached the stage where oversupply or overcapacity can create a drastic price drop. In other words, since they manage to sell whatever they produce, why should they improve their product quality? Likewise, producers tend to wait for a guaranteed market before they all engage in the production of a given commodity. This also applies to some exported commodities.

To my understanding, market demands must be analyzed in detail before production decisions can be undertaken. Of course, without production, selling efforts can hardly be envisaged. The usual evolution is that domestic production develops itself through production for the internal market. Producers learn and master the process of supply for the domestic market on a regular basis, meeting all quality standards, sufficient quantity, and offering a competitive selling price. In doing so, the producers gather experience over time, which will prepare them for exporting. In this way, the grouping of small-scale producers is essential in order to implement the concept of contract farming. This practice will ensure that production is market-oriented and functions under a certain contractual framework regarding the supply of production. This practice will also help reduce risk.

Factors influencing the competitiveness of a given product

This general description can be examined at three different levels:

At the macro level

National economic stability and growth is an important factor in improving domestic production.

A legal framework that is conducive to economic development, and to domestic and foreign direct investment and trade, is equally crucial in order to foster a sufficient number of successful exporters. From the perspective of competitiveness, the national legal framework should be carefully designed to create a safer environment and be more attractive to foreign investors. Problems here exist in land leasing and ownership, financial incentives, in granting investment licenses, in the registration of businesses, and in the import and export procedure. These features cannot be improved unless a comparative study of the investment policies and legislation of neighboring countries is undertaken. In the last few years, the government of the Lao PDR has reviewed its investment policy and has streamlined the procedures. However, much remains to be done since other countries in the region have a more competitive edge which is constantly reviewed and improved.

At the sectoral level

There is no clear-cut distinction between treating an issue at the sectoral or national level, but for the purpose of this analysis, the following issues will be considered at sectoral level. Laborers, transport via third countries, domestic transport costs, capital costs and credit access are among the cost burdens for most companies, and factors which affect their competitiveness. At this level, closer attention should also be paid to production costs. Fuel cost is competitive at least with Thailand and Vietnam, whereas electricity costs are not as cheap as in the country exporting it. Despite the fact that the government has invested substantially in infrastructure building, the costs related to the utilization of these facilities are not competitive because of different levels of government support of each country. Richer countries tend to subsidize their agriculture to such an extent that production does not operate according to market forces. This intervention has a trade distorting effect.

Let us use the example of fresh water fish rearing in Nongkhai, Thailand. Fish reared in ponds are imported from Nongkhai to supply the Vientiane market. The competition does not only relate to trade but starts from the production stage. Questions like why Thai fish cross the Mekong to Vientiane are answered by the fact that they can produce more fish of better quality on a commercial level. Their unit cost is lower for a number of reasons and their extension service is more equipped technically and financially. For example, they supply irrigation facilities at a subsidized rate, fish ponds can be dug free of charge, seeds and breeding stocks are supplied, and they get free technical advice. Conversely, farmers on the Lao side have to pay for these inputs at a higher cost. It is also true that Thai fish are reared in a more technologically advanced manner using manufactured fish feed, and artificial insemination so as to increase the reproduction rate, whereas Lao fish are mostly reared using natural or less advanced methods. The result is that different final products are obtained. The former method justifies and enables the economics of scale.

Another example is of a furniture company which obtained a significant order for knock-down furniture with a well-known Swedish importer. However, once the market was secured, the company ran into another set of problems such as a short supply of raw materials, and access to credit. Due to the allocation method of wood, the needy and most promising firm might be left in short supply despite the general availability of the resource. Access to credit is difficult not only because of the scarcity of capital, but because the loan procedure itself is complicated.

The general assumption is that the main constraint to the extension of production is market access. To many people's surprise, even one small problem can impede the whole production process. For a successful production undertaking, there needs to be a much more comprehensive approach on a continual basis, where all factors play a part. Thus the competitiveness of a product must be seen as a combination of the various strengths of a company in order to make use of the market opportunities.

At the company level, issues concerning finance, marketing, production, personnel and general management must be strengthened in order to create a capable exporter. Our exporters are mostly small and medium size enterprises with limited knowledge of foreign markets. In this regard, marketing strategies such as product planning, export pricing, distribution channels and marketing promotion should also be considered. In the product planning, product design, grading and standardization of a product, packaging and branding are key elements in competition. In addition, trade fairs and exhibitions, advertising, and business trips are crucial for marketing. The export price must also be competitive enough.

Contract farming mentioned before will act as a guarantee for a stable price and market outlet or distribution channel. For the purpose of selling agricultural products to overseas markets, export marketing and marketing of agricultural products are essential tools for all business practitioners.

Policy recommendations

To strengthen the production capacity and competitiveness of local firms, the government should seriously consider the following factors:

1. Pursue its investment in infrastructure, since the lack of, and high cost of infrastructure (transport, telecommunication, power, etc.) means lack of competitiveness.
2. Technical support must be provided at minimum cost. In addition to investment in infrastructure, a public investment program should also be geared at recurrent expenditures and extension or promotion programs. The introduction of modern technology should be encouraged by the government. The government should also consider funding research and other permissible domestic support as long as it does not contradict the world trend.
3. Human resource development should be another top priority. Educational and research institutions should be strengthened in terms of capacity and their academic work should be linked to the practical world. These institutions should also be put to work to help local producers and business practitioners.
4. Trade negotiations in bilateral and regional trading arrangements should be conducted in order to solve tariff and non-tariff trade barriers. The trade sector will take the lead in the process of economic integration.
5. Legal framework should be strengthened in order to ensure law enforcement, and to create a pro-business investment climate in this country. The integration in the regional and world trading system has no other intended purpose than to attract FDI in order to produce exports. A comparative study of FDI should be carried out in order to position Lao PDR in the regional context.
6. Sectoral issues should be dealt with by various government agencies with the goal to assist the business community in their productive and trading endeavors. All socio-economic sectors should deal with production and marketing problems.
7. The issue of labor productivity should be seriously analyzed, since only skilled labor with modern technology can efficiently and effectively exploit the country's natural resources. This is a prerequisite for a company's or nation's competitiveness.
8. Market reform should be pursued and market imperfections should be addressed by the government. Entrepreneurship and managerial skills should be promoted among commodities producers and in the business community.

Financial Sector WG

1. An Overview of the Laotian Fiscal and Financial Sectors

Masaaki KOMATSU

Focusing on either the fiscal or financial sector in Laos, four papers have been written and submitted by Japanese and Laotian authors, with a separate paper dealing with both the fiscal and financial sectors also prepared and submitted.

Fiscal Sector

The paper authored by Hirohata, Yamashita and Domoto discusses the problems associated with the decision-making process for public investment, focusing on those relating to the public investment management system (lack of a unified system) and the public investment decision-making mechanism that underpins it. In recent years, both the public investment management system and public investment decision-making mechanism have been undergoing change as a result of the issuance of the Decree on 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 to the Department of International Cooperation of the Ministry of Foreign Affairs. The paper predicts that unifying the management of public investment decision-making will be difficult under the new system, citing Laos's high dependence on international aid in its public investment and development program as the main reason. 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 giving rise to a potential conflict between the goals of the development program and the choice of individual projects. For this reason, close coordination and cooperation is required between all government bodies involved in public investment, includingthe 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 relationship of checks and balances with one another. In the medium to long term, foreign aid projects will entail maintenance and management costs, thus pushing up fiscal expenditures in the future. For this reason, decisions on foreign aid projects needs to be made after carefully considering their affordability in terms of future costs and fiscal revenues.

Panom's paper discusses the issue of the procurement of development funds through the issuance of government securities. It first explains Laos's economic situation, fiscal and financial situation and the like to help policymakers grasp the economic reality, and then goes on to discuss the development of government securities markets and procurement of development funds through it. In chapters 1 to 3, the paper focuses on the explanation of economic development and trends in monetary policy and fiscal policy, while in chapter 4, it explains treasury bills (T-bills) and Bank of Laos bills (BOL bills), as well as describing the status of the issuance of those bills. Chapter 5, on the other hand, is dedicated to the discussion of issues such as the procurement of development funds through the issuance of government securities and relationship between the development of government securities markets and monetary policy. Furthermore, the paper 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 between 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.

Financial Sector

Koyama's paper provides advice on the proposed establishment of a development finance institution (DFI) after reviewing the progress of financial reforms in Laos. Many Laotian banks are marred by an excess debt problem, and the banking system is currently undergoing a rehabilitation process under the supervision of Bank of Laos and ADB advisers. According to the recent balance sheet of the banking sector, deposits have been steadily increasing, while the loan balance has been slow to grow, resulting in a fall in the deposit-to-loan ratio, which is an indication that banks are failing to fulfill their financial intermediary function. The paper also points to signs of a credit crunch, in which banks hold back credit even from sound borrowers. Against this background, the Laotian side has expressed a strong desire for an investigation into the 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 those apt to be catered to through public financing; (2) Maintenance of independence and autonomy of loan decision-making; (3) Mobilization of domestic savings as the first choice for raising capital for loans. The fostering of healthy financial institutions 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 those relating to 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 correct procedure for the establishment of a DFI, with the stabilization of the macroeconomic environment being top priority.

The paper prepared by the Laotian side's Finance Working Group (Dethphouvang, Phouthanouphet, Sthabandith and Oula) examines the establishment of a development finance institution (DFI). It first argues for an urgent need for the establishment of a DFI, citing several reasons. These are: (1) The existing Agriculture Promotion Bank (APB) is undergoing change as part of the banking system reform, and is set to become a commercial bank in the future, giving rise to a need for an organization that will take over the provision of policy-based loans for the poor, a function which have so far been the responsibility of the APB; (2) At present, commercial banks are very cautious about extending loans amid a general credit restraint trend, leaving numerous would-be borrowers without access to loans; (3) Large untapped demand for long-term funds, particularly that from state-owned enterprises (SOEs) and small and medium enterprises (SMEs); (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 event of the establishment of the proposed DFI on the basis of Japan's experience (Development Bank of Japan), drawing a lesson from it regarding a board structure aimed at 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 factors and conditions involved in the establishment of a DFI in today's Laos.

Fiscal and Financial Sectors

Komatsu's paper briefly reviews the structural characteristics of the fiscal and financial sectors, and discusses major issues arising from them. In Laos, problems with the banking sector and those with the public finance sector are intertwined, and chapter 1 deals with this issue. The massive bad debts that the banking sector is saddled with cannot simply be blamed on a lack of risk assessment capabilities on the part of 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, therefore, 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. The real reason for the Laotian government proposal for the establishment of a new DFI lies here. 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? That is the subject of Chapter 2. 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 GDP by 2002, so it is not desirable to push it any further. 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.

2. Issues and Challenges for Decision-Making on Public Investment in Lao P.D.R.

Nobuo HIROHATA
Eri YAMASHITA
Kenji DOMOTO

Summary

Since the Laotian government adopted the 'New Economic Mechanism' in 1986 and the Laotian economy embarked on its transformation to a market economy, Lao P.D.R. has been continuously working on economic improvement and the fiscal stability, doing so in conjunction with the assistance of international donors. This paper analyzes the current situation of finance and assistance of international donors in Lao P.D.R.

In the effort to improve government decision-making on public investment, several problems will need to be addressed. The first is the lack of a unified system of management for public investment as a whole. The second involves the decision-making mechanism on which such a unified management system must rest. The third is the level of overall investment, but discussion will be limited to the first two issues in this paper.

Both the management system and the decision-making mechanism for public investment are in the process of change due to amendments stipulated in the "Decree on PIP Management" (N58/PMO) issued by the Prime Minister's Office. Organizational changes are among those under way. Matters involving foreign aid and external borrowings, heretofore the province of the Committee of Planning and Investment, are now controlled by the Department of International Cooperation of the Ministry of Foreign Affairs.

Judging from the new system, unifying the management of public investment decision-making will not be an easy task. When projects must be prioritized within the limits of a fixed public investment budget, the tendency is to favor those that involve foreign aid or foreign loans.

Resolving the issues will require complete coordination among 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, Department of International Cooperation of the Ministry of Foreign Affairs, and all other entities involved. It is important that these organizations build not only ties of cooperation, but a relationship of checks and balances as each evaluates the others from its own particular viewpoint.

The decision-making process for public investment should serve the balanced developed of the nation as a whole. All projects should be considered from the larger viewpoint of how best to correct the regional imbalances that now exist.

In the longer term, there is the question of how to deal with costs that accrue after a project's completion. Since this will become increasingly urgent as the number of projects grows, future maintenance and management costs must figure in even the initial decisions on whether to implement a project.

2. Issues and Challenges for Decision-Making on Public Investment in Lao P.D.R.

Introduction

The following chapters attempt to concretely identify the problems, as well as constraints for the government in issuing national bonds for the purpose of domestic financial resource mobilization. Major issues to which we should pay attention are as follows:

(1) Government efforts in recent years for tax collection and expenditure control

In the past couple of years, the government has been making efforts in establishing and restructuring relevant organizations for government revenue and expenditure control. We should review and evaluate these efforts and their effect on the government's fiscal performance. It should be an important step forward.

(2) Possibility to increase government revenue and to decrease fiscal deficit by new organizations and new tax scheme in coming years

Based on the review of recent government efforts, we should discuss the possibility for the government to decrease the fiscal deficit in coming years from the viewpoint of administrative capability. We will have reached the point at which the government needs to make more efforts to manage the fiscal deficit. The possibility of introducing a drastic rule should also be discussed to some extent, from the standpoint that fiscal deficit control is an indispensable condition for the future of the Lao economy.

(3) Financial development phase of the Lao economy and its significance on the development of the domestic financial market

Hypothetically, a rapid increase in the money supply would raise the CPI (consumer price index) significantly, especially in the case of the Lao economy. First, Laos has to import much of its nondurable consumer goods formally as well as informally. Second, infrastructure services such as road transportation would take a relatively long time to deliver social and economic benefits, especially for the production sector which is still quite small. Third, foreign currencies are in fact used freely among ordinary people.

These three points will lead us to the conclusion that asset substitution will happen whenever the money supply is increased rapidly. We should note these issues more seriously. That might imply that monetary stimulus will have a social cost on a large scale unless domestic production increases sufficiently as soon as possible.

(4) Rethinking of pump irrigation investment since 1996

Although the role of the government in promoting production activities especially in the private sector is important for an economy like Laos, "more than enough is too much." We should review and discuss the effect and result of the pump irrigation project from the mid-90s from a viewpoint of financial market development. In order to promote production activities as a whole for the future, we need to understand who (organization) did what (fiscally and financially) at that time. Those effects should be reviewed in detail to seek a desirable direction of public investment policy.

(5) Possible costs and benefits of raising domestic funds by issuing government bonds in coming years

Based on outcomes of the abovementioned analysis, costs and benefits of the issuance of government bonds should be discussed as concluding remarks. Hypothetically, domestic fundraising through government bonds and large-scale construction projects would be causes of inflation, and would be serious obstacles to developing the financial market.

On the other hand, the possibility of a bond issuance to cut inflation should also be considerably discussed. Under the condition that the government faces a continuous fiscal deficit, repayment itself would be a critical burden for the government and it would cause inelastic fiscal management, which would deteriorate social public service quality, especially in the rural areas.

In the following sections, closely relevant issues will be discussed from these viewpoints. And concluding remarks will be given on the role of the government and major donors.

Chapter 1. General View of Finance and Fiscal Issues in Lao P.D.R.

1. General Issues of Finance

Lao P.D.R. has experienced a difficult fiscal situation since its establishment as a nation, but it deteriorated especially after aid from the former Soviet Union was stopped in the 1990s and the fiscal debt increased by 109.5 times between 1986 and 1998. The fiscal debt ratio has remained at around 7-8% of gross domestic product (GDP), except for 2001, after having peaked at 12.9% in 1997. The biggest reason for the debt increase is the increase in capital expenditure. In particular, the investment in irrigation infrastructure, aiming to realize food self-sufficiency and graduate from the Less among Least Developing Countries (LLDC) level by 2020, comprised 5% of GDP in 1997 and 1998 and reached 70% of the total expenditure. After 1998, the government increased the salary of public officials and the amount of transfer expenditures, such as national pension, taking into account the advice from international organizations; and this led the increase of current expenditure, which consequently decreased the capital expenditure ratio.

Since Lao P.D.R. joined the ASEAN Free Trade Area (AFTA) in 1997, the Laotian government has been decreasing the import tax ratio little by little in accordance with the Common Effective Preferential Tariff (CEPT) scheme, and this is considered to be a concern that affects the future fiscal situation in Lao P.D.R. The national budget deficit is covered by foreign aid capital. The Laotian government declared in the annual meeting of the IMF-WB in October, 1999 that it would try to strengthen its national finance by targeting a revenue rate of 12% of GDP. Also, in its political dialogues with donors, the government confirmed that it considers the improvement and innovation in the management of macroeconomics to be fundamental to the improvement of national finances and one of the core challenges of Lao P.D.R.

Table 1-. Fiscal Index (Billion Kip)

	1990	1995	1998	1999	2000	2001	*2002	**2003
Total Revenue	61	162	1,462	2,167	2,476	2,568	2,772	3,282
Total Revenue/GDP (%)	9.9	11.4	16.5	16.9	16.0	14.8	12.9	13.4
Tax Revenue	38	135	746	1,367	1,629	1,879	1,904	2,344
Non-Tax Revenue	23	27	184	324	372	449	414	473
Grants			532	475	476	240	453	465
Total Expenditure	143	290	1,719	2,755	3,141	3,161	3,992	5,074
Total Expenditure/GDP(%)	23.4	20.4	19.4	21.5	20.3	18.2	18.6	20.7
Current Expenditure	70	143	391	948	1,096	1,252	1,524	1,956
Capital Expenditure	74	147	1,270	1,704	1,911	1,785	2,345	2,829
Interest			59	103	134	124	123	289
Net	-82	-128	-257	-588	-665	-593	-1,220	-1,791
Net/GDP	-9.7	-3.9	-2.9	-4.6	-4.3	-3.4	-5.7	-7.3

*prospected **planned

cf) fiscal years are from Jan. to Dec. in 1990. After 1995, fiscal years are from Oct. to Sep. Excluding aid revenue
Source:JCIF Quarterly Watch 2004 the first quarter

According to the Ministry of Finance of Lao P.D.R., the Laotian government set up and is currently implementing the following policies to improve the country's finance.

<u>Fiscal Policies for Five Years (2000-2004)</u>

1. Maintain economic and financial stability in order to enhance the confidence of people and investors in the national currency.
2. Improve the budget balance in order to increase saving, by uncovering new revenue sources and mobilizing all revenue potentials, while ensuring a balanced and focused capital investment structure to ensure equitable redistribution.
3. Ensure the effectiveness of the financial inspection measures so that they serve as real tools of the financial sector in the macro adjustment.
4. Eliminate subsidies to state owned enterprises: lending activities should be associated with their repayment capacity.

5. Improve accounting systems in the government, expanding their use and promoting their implementation in simple transition.
6. Attract grants and concessional loans.

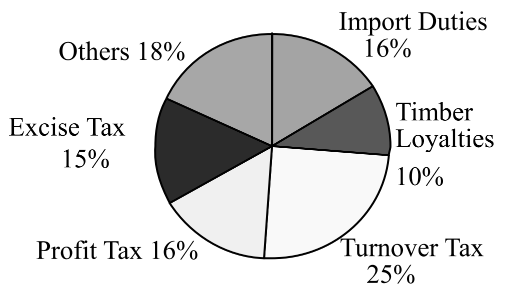
<u>Lao P.D.R. Macroeconomic Target (2000-2004)</u>

- Budget revenue: 14-18% of GDP.
- Budget deficit : less than 5% of GDP in 2005
- Public saving to GDP: increase from 4% at present to 10% in 2005.

２．Revenue

Tax revenue comprises 80% of total government revenue in Lao P.D.R. This situation originated in a tax policy initiated in 1987. This policy mandates the tax payment for all kinds of enterprises, and the payment previously rendered as ‘donation/trust money’ by national enterprises is now collected as ‘tax’ (there is strict enforcement and an absence of shelters) through the reform of national enterprise management. The top tax sources are import duties, timber royalties, turnover tax, profit tax and excise tax (see chart 2), and these five comprised 82% of total tax revenue in 2002.

Table 1-2. Tax Revenue Source in



(Source: MoF)

The volume of import duties is expected to decrease due to AFTA regulations such as CEPT, and the government needs to expand and strengthen the tax base in order to secure future national revenue. One measure taken for this is the implementation of value added tax (VAT): the government is targeting the introduction of VATs for the year 2006 but struggling in the process. Additionally the project requires the improvement of efficiency in tax collection and thus decentralization has been implemented to supplement the enforcement of tax collection in the countryside. Other measures such as the promotion of both private small- and medium-sized enterprises and production and import of high-value-added items have been discussed as well. Regarding the introduction of VATs, the grasp of correct and complete figures of items for tax imposition is a necessary condition. The government is currently introducing an accounting system to collect information such as enterprises’ revenue, capital and sales; however, further refinement of the tax collection systems will be required. The existences of informal sectors, the circulation of US dollars in the domestic market and other related issues have to be addressed in order to gain complete control of domestic economic activities and to strengthen tax collection.

The following policies have been set to secure new sources of revenue and facilitate its collection:

- Reform custom duties and other related policies to adjust them to economic development.
- Strengthen the management of public investment, especially by promoting efficiency in national enterprises to generate more revenue.
- Collect administration fees in some sectors and optimize their use.
- Inspect and audit the enterprises and departments on a regular basis.
- Promote the establishment of joint ventures.

３． Expenditure

The expenditure ratio to GDP has stayed around 20% over the past few years, but it has shown a slight increase every year, mainly in capital expenditure. The main cause of this increase in capital expenditure is a huge investment for irrigation and rural development to secure food sufficiency. In response to this increase, the government has established new regulations such as the one that obliges workers to file their operational cost as a part of their salary system. This government initiative has helped to correct the current balance, and the expenditure ratio to GDP has been decreased.

As to capital expenditure, ongoing discussions are focusing on forming a framework to mobilize domestic capital and transfer some project management from the central government to local communities. However, public investment expenditure, which is twice the size of capital expenditure, cannot be sustained by the national revenue. In the budget plan of 2003, 2.3 trillion kips (9.2% of GDP) is financed by grants from international donors and foreign institutions.

The government set up the following policies for expenditure management.

- Make the growth rate of expenditure and salary lower than that of revenue and focus on improving the salary system and in-kind allowances to a reasonable level and on eliminating unnecessary subsidies and wasteful spending.
- Improve public investment policy by requiring more efficiency to realize the reform of the national economy structure.

In the 2000-2004 five-year fiscal plan, the following issues are listed as discussion topics: the introduction of a trust fund, the acquisition of investment funds for big projects at a low interest rate, the strengthening of expenditure management by enabling the introduction of a bid system, supervision, and evaluation mechanism, the provision of low-interest capital to the public by issuing long-term national bonds, the establishment of a market to sell and buy public bonds and stocks, the establishment of a village development fund, and other related policies. Currently, a pilot project called 'One Product in One Village' is being practiced to generate income-earning activities by creating a cooperative in each village.

4． Public Investment

Total public investment is double the size of current expenditure and cannot be maintained only by the revenue of Lao P.D.R. In the 1990s, the government resorted to issuing more currency to finance the public investment, which consequently caused inflation. Having learned from that experience, Lao P.D.R. is working on the reform of fiscal regulations with support from international organizations. Currently, it is basically forbidden to issue national bonds for debt payment, with the only exception being the issuance of short-term bonds for fiscal balance control. Also the country's central bank is prohibited from absorbing bonds. There is discussion on whether to establish a bond market in the country, but special consideration will be required regarding the issuance of national bonds with favorable interest to attract capital injection by investors, because the economic situation of Lao P.D.R. suffers from chronic debt and a low internal savings rate. The reasons for this low rate and for a monetary base M2-to-GDP ratio of 17% are the unstable macro-economy, low financial deepening, and low credibility of banks. The government aims to improve efficiency and effectiveness of public investment management by creating revenue sources, improving its procurement process and securing the transparency of the process.

Table 3-1. Index of Public Investment, M2, Savings in Lao P.D.R.

	1998	1999	2000	2001	*2002	**2003
	391	948	1,096	1,252	1,524	1,956
National Public Investment	290.5	1,295.1	1,914.0	2,115.4	2,136.4	2,515.6
to GDP (%)	6.9%	12.5%	14.0%	13.5%	11.7%	12.3%
Ｍ２/ＧＤＰ (%)	20.4%	14.9%	16.5%	17.2%	18.7%	18.2%
Savings/GDP	NA	NA	19.4%	17.0%	18.1%	20.1%
% of government savings	3.4%	5.1%	4.6%	4.6%	4.7%	4.5%

*prospected **planneed

Source: MoF, Lao P.D.R.
cf) Source for M2-to-GDP is from ADB Indicator

As an effect of debt, capital is occasionally sought as an alternative source of funding in the financial sector, which may cause further non-performing loans. To avoid serious non-performing loan problems, it is necessary to promote the separation of fiscal policies and monetary policies, establishing a framework by which fiscal and financial policies can function independent of each other. The government is currently addressing this issue and is gaining the approval of some international organizations in their respective projects.

Prime Minister's Decree No.192 (2000) delivered the decentralization; the authority of tax collection was transferred from the central government to the local authorities in each province. It also made each province responsible for establishing strategy units and budgeting its own distribution framework and made local authorities inside the provinces responsible for establishing detailed and concrete budget plans and five-year plans. The responsibility of the execution now rests with the villages, and the role of the central government is limited; it only instructs techniques and monitors. The aim of this decentralization is to have real conditions reflected and real needs addressed to promote and improve the revenue acquisition. An effect of this policy, however, is that the central government now struggles to grasp the situation of the macro-economy, especially that of tax revenue. Furthermore, a new incentive that permits local authorities to obtain half of the surplus of the centrally assigned tax collection quota is not functioning to increase the revenue as it had been expected, whereas public project spending is executed as planned. As a result, the government finance fails to obtain capital provision and resorts to money-lending from the private sector and deferment of payment. Thus, the gap between the central government and local authorities in policies and priorities is one deterrent to the financial reform and further arrangements for decentralization is necessary.

The privatization of national enterprises has been implemented since 1989. One of the reasons for the privatization is to deal with non-performing loans generated by national enterprises. The government is executing a tax system reform and structural adjustment, and reduction of subsidies. The Prime Minister's Decree No.54 established a framework to execute annual audits and evaluate the fiscal condition and management systems of national enterprises. Regarding the evaluation of the fiscal condition, the government aims to collect more qualitative information and evaluate performance in terms of profitability, payment capacity, fluidity, bond management and management structure. Regarding the evaluation of systems, it will check management, the management capacity and the feasibility of business plans. It is expected that the reform of national enterprises will contribute to improvement in the fiscal situation of the Laotian government.

Chapter 2. Trends of International Donors in Lao P.D.R.

1. The World Bank

The World Bank has provided a total of 740 million dollars as IDA credit to 36 projects since 1977 when it launched the first project in Lao P.D.R., and among them, 23 projects had been completed (as of July, 2004). A variety of areas are covered by those projects: agriculture, education, energy, health, infrastructure, and environment.

The World Bank composes Country Assistance Strategies (CAS), which it distributes to governments, international donors and NGOs widely. CAS are documents to be used for analysis and evaluation of priorities for investment items to be developed in the country and for information on the World Bank's program selection process. The Lao P.D.R. team of the World Bank exchanges ideas and views to discuss with Laotian congress members and specialists in each area in composing CAS for Lao P.D.R. The World Bank also conducts surveys and exchanges ideas with the government, the private sector, civilians, and other international donors concerning its projects and activities and the development strategies of Lao P.D.R. The CAS established in 1999 is the latest, but a revision is under way, reflecting the purpose and goals of the Interim Poverty Reduction Strategy Paper (I-PRSP), the National Poverty Eradication Program (NPEP), and the National Five-Year Plan on Social and Economic Development. The new CAS will focus on capacity building of each sector, and reform in terms of regulations, structure, and human resources in the government, to promote national development.

The World Bank's long-term objectives in Lao P.D.R. are (1) poverty reduction, (2) stabilization of the economy, (3) development of rural areas and infrastructure, and (4) human resource development. These objectives comply with the development policies of the Laotian government. By sector, in the past the energy and transportation sector has had the biggest share of the World Bank lending to Lao P.D.R. Currently the World Bank is conducting a study and discussion to finance 1.5 billion dollars to guarantee 25% of the national bonds for the Nam Theun 2 hydropower development project. In addition to its finance activities, the World Bank also conducts public investment reviews, develops strategy on rural infrastructure, surveys the effects the Asian financial crisis and so on.

２. International Monetary Fund (ＩＭＦ)

Lao P.D.R. joined the IMF in July 1961 and has received Structural Adjustment Facility (SAF), and Enhanced Structural Adjustment Facility (ESAF). In recent years, Lao P.D.R. has received loans of SDR 20.51 million in 1989, and SDR 35.19 million in 1993. Lao P.D.R. became one of the 77 nations eligible for Poverty Reduction and Growth Facility (PRGF) and it received a 3-year loan of SDR 31.70 million in 2001. In the third PRGF review held in 2003, the effectiveness of the PRGF in Lao P.D.R. was confirmed and the finance was authorized to be extended for one additional year, until 2005. This PRGF is expected to be spent mainly on the stabilization of the macro-economy of Lao P.D.R. and the structural adjustment in related areas. In particular, the improvement of the tax framework for the improvement of fiscal conditions, the introduction of an accounting system for expenditure management, and the strengthening of external debt management are the main targets.

３. The Asian Development Bank

The Asian Development Bank (ADB) is the biggest donor to Lao P.D.R. As of December 2003, it has received more than 60 financial arrangements totaling more than one billion dollars. This assistance by the Asian Development Bank promotes the strengthening of the Lao P.D.R.'s international competitiveness and the creation of value in the country through long-term initiatives: development of the private sector and small and medium enterprises to secure employment, and development of a structure and capacity for country's decentralization. Although the Asian Development Bank ensures the independence of its projects, it also takes into account other donors' projects and initiatives, aiming for harmony and the correlation of projects. The Asian Development Bank also has other initiatives that are part of the Greater Mekong Sub-region(GMS) development framework and they enable Lao P.D.R. to benefit other nations along the Mekong River, and enable Lao P.D.R. to receive benefits from other nations. Technical Assistance support is also actively provided in various areas from urban infrastructures to production marketing for poverty reduction. The January-to-March 2004 statistics by the ADB show that Lao P.D.R. ranked second after China as a recipient of the Technical Assistance support from the Asian Development Bank.

By sector, the transportation and communication sector occupies 30% of total finance, while the social infrastructure sector and the energy sector each account for 20%. Based on inter-government dialogues, the focus is currently on poverty reduction through a community-based and participatory approach and the priorities are the following five areas: (1) rural development and its market access, (2) human resource development, (3) sustainable environment management, (4) private sector development, (5) unification of Mekong area.

According to the finance plans for 2004-2006, half of the all financing will be allocated to poverty reduction projects. On one hand, the Asian Development Bank focuses on Northern areas where the poverty rate is quite high. On the other hand, it has promoted the development of Lao P.D.R. as a component of the development of the GMS comprehensively, especially focusing on the regional development along the East-West Economic Corridor that goes across Savannakhet, through financing areas such as electricity infrastructure, telecommunication infrastructure, tourism development, and other related development projects. New initiatives such as the simplification of immigration procedures at the borders of the East-West Economic Corridor are being implemented and are expected to benefit the economic development of the entire GMS.

４．Official development assistance (ODA) policies of Japanese government

The initial occasions of Japanese government aid to Lao P.D.R. were projects for water sanitation in Vientiane and a feasibility study for the development of Gogam Bridge, both in 1957. Japan has continuously provided aid since then, even through the period of the socialist regime in the 1960s, and as of 2002, total official development assistance (ODA) in 2002 values was about 700 million dollars in grants and 300 million dollars in technical assistance. Additionally, Japan has offered loans totaling 1.3 billion yen as of 2002 and Japan has been the top bilateral donor to Lao P.D.R. since 1991. The share of Japan among all countries from which Lao P.D.R. receives bilateral aid has also grown from 12% in 1992 to 50% in 2000. On the other hand, Lao P.D.R. received the 16th largest amount of Japan's bilateral aid in 2002.

Japan’s policies for development assistance in Lao P.D.R. are based on its ODA Charter. In 1998, a mission on economic cooperation was dispatched to Lao P.D.R. for a political dialogue. It determined that the following areas would comprise focal points in Japan’s future assistance policies: (1) human resource development (2) basic human needs (BHN), (3) agricultural and forestry industry, (4) infrastructure development. The effectiveness of such assistance was confirmed in a political dialogue with the Laotian government in July 1999.

In human resource development, ODA supports capacity building in public sectors in line with the open economy policies of Lao P.D.R.: development of higher education and training of both technical officers and strategists at the working level in both the public and private sectors and the recent focus has been on capacity building in financial and banking sectors. Under the project for *‘Human Resource Development Scholarship,’* many young public officers have been dispatched to study in Japan every year since 1999. As to BHN, new fields such as primary education and environmental preservation were added to health and medical fields, which enable Japan’s ODA to address a wider range of BHN, using multidimensional approaches. In the agriculture and forestry industry, active support has been offered in projects for development of irrigation facilities and rehabilitation of farms. Recently there has been support in soft areas—for example, in support for implementation of agricultural policies. Infrastructure development has been consistently focused on as a core sector for ODA to support and Japan has provided many projects such as construction and rehabilitation of main roads, bridges, and other social infrastructure. In 2001, a loan of about 4 billion yen was authorized and provided for the project for a second Mekong international bridge. This project, the construction of a bridge to connect Thailand and Lao P.D.R., is a part of the Economic East-West Corridor project, and the first “regional” project in which Japanese ODA was offered to two or more countries jointly. As for harmonizing the assistance with that of other donors and NGOs, discussion and exchange of ideas are often practiced at roundtables.

５. The Japan International Cooperation Agency (JICA)

The framework of JICA’s assistance is categorized in eleven areas: (1) project identification/formation/evaluation; (2) feasibility study; (3) technical training programs; (4) dispatch of experts; (5) dispatch of Japanese Overseas Cooperation Volunteers (JOCVs); (6) dispatch of senior volunteers; (7) follow-up activities; (8) development welfare projects; (9) support for grant aid programs; (10) project-type technical cooperation; (11) development partner programs. In regard to JOCVs, Lao P.D.R. is one of the first countries to which Japan dispatched a JOCV group in 1965, and since then Lao P.D.R. has accepted more than 200 JOCVs (as of 2002) in various areas such as health, agriculture and fishing, education and culture.

JICA provides support in the four focal areas in accordance with the ODA charter: human resource development, BHN, agricultural and forestry development, and infrastructure and energy. In human resource development, JICA recently has given special support for the dispatch of Japanese experts to Lao P.D.R. and the invitation of Laotians to Japan in order to train public officers for the transformation to a market economy and legal framework development. JICA also actively provides support in the development of higher education: the establishment of university education, human resource centers, and training courses. In addition, various types of support programs have been offered for development of technical officers.

In the BHN area, JICA set up development strategies for the improvement of public sanitation, the condition of which is quite low by international standards, the establishment of local hospitals, the dissemination of primary education in villages and mountain areas, and the improvement of the living environment including the improvement of urban environment and environmental management in industries, in order to lessen the gap in the level of social service between cities and countryside and to raise the standard of living of the nation as a whole. Agriculture and forestry is the major industry of Lao P.D.R. that contributes to the stability of the national economy as well as to the self-sufficiency of the population. Total support covering rehabilitation of facilities, dissemination of technology and development of management structure in the agriculture and forestry field has been provided to complete the development objectives of the Ministry of Agriculture and Forestry. Infrastructure and energy is considered to be an indispensable core for the dissemination of basic social services and network development of both the entire nation and the Mekong region as a whole, and support has been provided along with other projects in transportation, telecommunications, electricity and energy, tourism. In 2002, JICA supported the preparation of Lao P.D.R.'s the Poverty Reduction Strategy Paper.

６． The Japan Bank for International Cooperation (JBIC)

JBIC has provided four loan programs totaling 13 billion yen for Lao P.D.R. The first loan was for the Nam Ngum hydropower project, providing 3.2 billion yen. This project was extended as the second project in 1976 with an additional 2 billion yen lending. The third project was also a hydropower project; 3.9 billion yen was financed for the construction of the Nam Leuk hydropower facility in 1986. The fourth loan was 4 billion yen finance for the second Mekong international bridge. This fourth loan was requested by both the Thai and Laotian governments in 1997, after a long period of discussion since the first feasibility study conducted by the ADB in 1990. JBIC provided consulting and advisory services to realize the contract signed in December 2001. In addition to those four loans, JBIC has provided overseas investment loans for in two cases for businesses, totaling 400 million yen.

The reason for a limited provision of loans is JBIC's concern for the repayment capacity of Lao P.D.R. However, based on the Japan-ASEAN action plan (December 2003) that announces the expansion of Japanese economic cooperation in the Mekong's regional development, JBIC is expected to increasingly participate in projects in Lao P.D.R. in the future.

JBIC is planning to expand its range of approaches in Lao P.D.R. including the utilization of overseas investment loans, by combining economic cooperation and trade and investment promotion. Furthermore, as a part of the process to increase the human resources availability in aid activities, JBIC is seeking partnerships with both various institutions including international organizations, private sectors and NGOs and countries surrounding Lao P.D.R. like Thailand and Vietnam. In terms of support areas, JBIC plans to expand its aid to include 'soft sectors' such as policy reform and structural improvement, in addition to infrastructure. Currently projects for the improvement of debt management and the strengthening of debt capacity are under consideration.

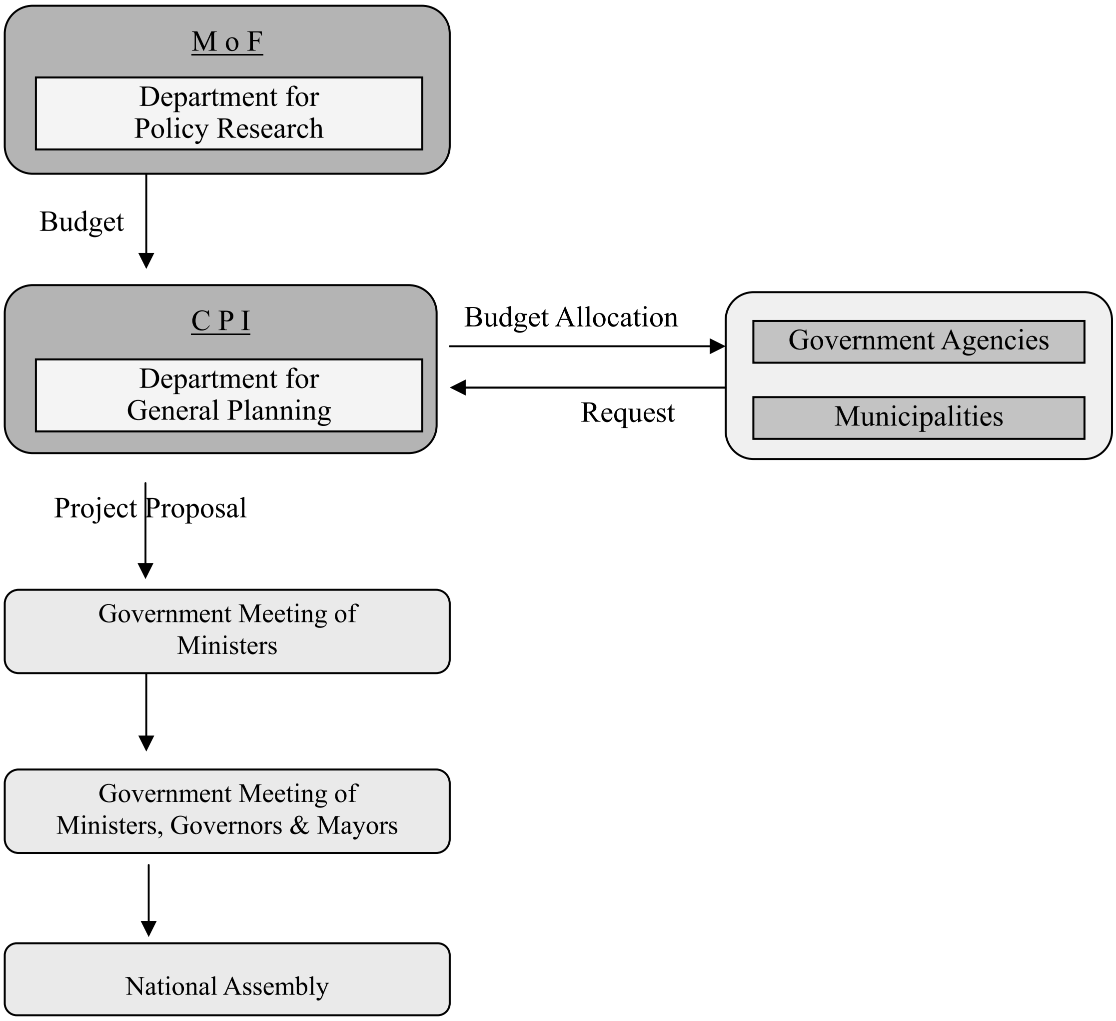
Chapter 3. Public Investment in Lao P.D.R.

1. Decisions on Public Investment

Decisions on any public investment paid for out of the national budget are based on an overall public investment budget determined by the Policy Research Department of the Ministry of Finance. Three factors are considered in determining the overall budget: ① estimated revenue, ② estimated foreign borrowings, and ③ estimated public spending.

Once the overall budget has been decided, the Committee of Planning and Investment, an organ of the Department for General Planning, presents allocation amounts for each government agency and municipality. These submit requests for public investment to the Committee of Planning and Investment, which establishes an order of priority for prospective projects based on certain criteria, including ① evaluations of each project, and ② government policies, regulations, and five-year plans.

Public investment projects are brought before the Government Meeting of Ministers and the Government Meeting of Ministers, Governors and Mayors. The final decision is made by the National Assembly.



Foreign debt plays a role in setting the budget for public investment as a whole. On a flow basis, foreign debt must be no more than 5 percent of GDP for the fiscal year; on a stock basis, outstanding foreign debt must not be more than 57 percent of GDP.

Projects supported by foreign aid have first place in the order of priority for public investment. Second place goes to ongoing projects initiated in or before the previous fiscal year. This means that new projects are prone to get short shrift in allocations.

In assessing individual projects for public investment, the Committee of Planning and Investment tends to give first consideration to schemes that promise the greatest economic benefit, followed by those that can be speedily achieved. Projects aimed at alleviating poverty are third in line.

This tendency can be seen in the committee's decisions on irrigation projects for agricultural land. Investment in this area has largely gone toward the repair and maintenance of existing facilities rather than to the construction of new ones, the principal aim being to increase the operation rate of little-used facilities. Large-scale projects, whose cost to users is greater than the cost of the goods produced, are being subjected to review. A “village fund” scheme is being promoted as well.

Determinations on public investment are made on different levels depending on the scale of the project involved. Projects of more than 50 billion kips (Group 1) are decided by the Government Meeting of Ministers and approved by the Prime Minister; those of more than 5 billion and up to 50 billion kips (Group 2) are approved by the chairman of the Committee of Planning and Investment and the ministers, governors and mayors concerned; those of 5 billion kips or less are approved by the relevant ministers, governors and mayors. One of the reasons for the transfer of authority to the local government is to ensure consideration of the specific needs of each district.

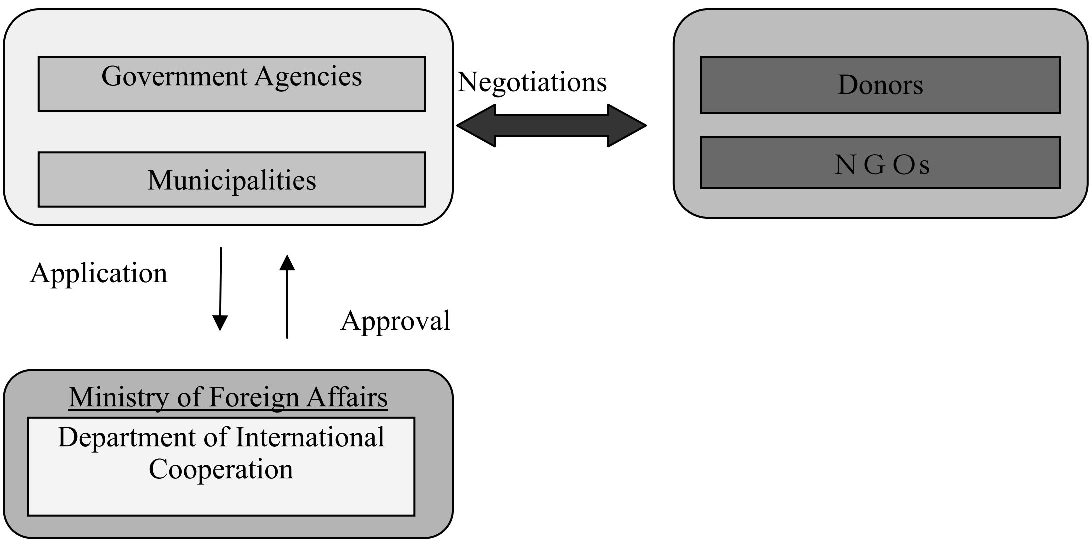
Table 3-4. Public Investment

(Unit: billion kips)

	2000/2001	2001/2002	2002/2003	2003/2004
Government share	872	995	1,060	760
Foreign capital	1,200	931	1,650	1,670
(Loans)	724	813	1,365	1,370
(Grants)	476	119	285	300
Total	2,072	1,927	2,710	2,430

２． Grants

Approval authority for grant-funded public investment projects rests with the Department of International Cooperation of the Ministry of Foreign Affairs. The procedural flow begins with individual government agencies and municipalities, which negotiate directly with donors, including NGOs. Projects ultimately developed are submitted to the Department of International Cooperation for final approval.



Counterpart funds required for grant projects include the cost of offices, facilities and equipment for the project, as well as personnel and other expenses. Maintenance and management costs are normally borne by the government agencies or municipalities concerned.

Over the medium- to long-term, the question arises as to how to pay the costs entailed in maintaining a project after its completion. These costs accumulate with each project implemented. Even when a project is funded by a grant, the agencies or municipalities involved must be sure to factor future maintenance and management costs – how they will be allocated, and how they will affect the government budget – into their initial decision on whether to go ahead with the project in the first place.

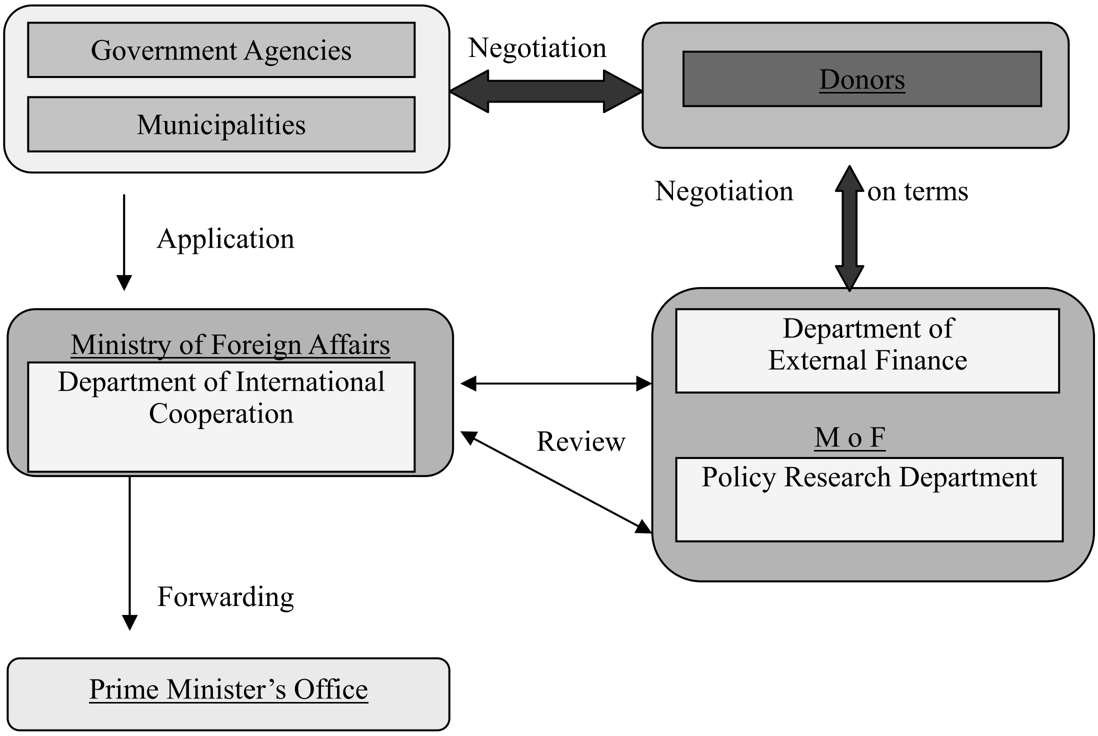
Entrusting grant negotiations to individual government agencies or municipalities leaves the system liable to inequity for a number of reasons. First, some agencies are better equipped to negotiate with donors, including NGOs, than others. These will naturally be in a position of advantage when grant decisions are made. Second, donors, again including NGOs, may, for reasons of their own, concentrate their grants in selected regions. It follows that a unified approach to negotiation would result in more balanced national development. Ideally, the government should use the inducement of projects as a means of addressing current regional imbalances. Coordination of this sort should cover public investment as a whole, including loan-based projects and those under the direct control of the government.

３．Loans

Supervisory authority for loan-funded public investment projects rests with the Ministry of Foreign Affairs’ Department of International Cooperation. As with grant-funded projects, individual government agencies and municipalities first negotiate individually with donors, including NGOs. They then apply for funding to the Department of International Cooperation, which, on the basis of criteria set down in government five-year plans, selects projects and assigns a level of priority to each.

The Ministry of Foreign Affairs negotiates with the Policy Research Department of the Minister of Finance on a ceiling for the projects that have been selected and assigns a level of priority. It also coordinates with the MOF’s Department of External Finance Relations on negotiations on terms to be conducted with donors.

When all procedures have been completed, documents are sent to the Office of the Prime Minister for approval.



Counterpart funds required for loan-financed projects are borne by the government. As is the case with grants, maintenance costs are covered by the government agencies or municipalities concerned.

Like grant projects, loan projects generate post-completion maintenance and management costs that mount as the number of projects increases. When deciding whether to go ahead with a project, government agencies and municipalities must take care to consider how these future costs will be paid, and what will be their effect on the government budget.

Government five-year plans are used as criteria in setting the order of priority. But here again, the potential for inequity exists in several respects: agencies that are better equipped to negotiate with donors, including NGOs, will naturally be in an advantageous position, and donors, again including NGOs, may, for their own reasons, concentrate on certain regions in funding loan projects. For this reason, overall coordination is needed in order to minimize regional imbalances. The coordination process should take in all types of public investment, including grant projects and projects funded by the government

More consideration needs to be given to the income-earning potential of loan projects. This is a vital issue because loan projects, unlike those supported by grants, involve repayment obligations that lie heavily on the budget for the next fiscal year. This suggests that those assigning priority to prospective projects should consider not only whether they satisfy the criteria provided in the five-year plans, but also whether they are important enough to justify significant borrowing.

One agricultural irrigation project was implemented on the basis of three considerations: ① that it would contribute to regional development; ② that it would be a clear help in reducing poverty, one of the central objectives of the five-year plan; and ③ that on paper, it had a high estimated earning potential.

However, a closer look at the situation would have raised questions. In the macroeconomic sense, Lao P.D.R. was already self-sufficient in rice production, with productivity expected to rise even further in the future. As neighboring countries were also self-sufficient in rice, there was little prospect for export. This would have had to question whether this particular agricultural irrigation project, whose specific aim was to increase rice production, was so necessary as to justify taking on debt in order to implement it.

Though estimates had found that the project had potential to generate high earnings, this finding is doubtful in light of the circumstance mentioned above. Since the project itself will not bring in adequate capital to repay the loan, funds for its future repayment will ultimately come from the economic development of urban areas. This project demonstrates why projects prioritized on the basis of five-year government plans must be selected on the basis of whether they are important enough to justify taking on debt.

Chapter 4. Problems in the Decision-making for Public Investment in Lao P.D.R.

In the effort to improve government decision-making on public investment, several problems will need to be addressed. The first is the lack of a unified system of management for public investment as a whole. The second involves the decision-making mechanism on which such a unified management system must rest. The third is the level of overall investment, but as this is affected by matters such as the level of government income and its causes in the economic environment, the level of public spending, and the feasible amount foreign borrowing, we will not concern ourselves with it here.

Both the management system and the decision-making mechanism for public investment are in the process of change due to amendments stipulated in the “Decree on PIP Management” (N58/PMO) issued by the Prime Minister’s Office. Organizational changes are among those under way. Matters involving foreign aid and external borrowings, heretofore under the province of the Committee of Planning and Investment, are now controlled by the Department of International Cooperation of the Ministry of Foreign Affairs.

Judging from the new system, unifying the management of public investment decision-making will not be an easy task. When projects must be prioritized within the limits of a fixed public investment budget, the tendency is to favor those that involve foreign aid or foreign loans. This tendency manifests itself in three ways. First, when an order of priority has been established under a unified system of management, projects at the top of the list may be passed over in favor of lower-priority schemes involving foreign loans. Second, it is not easy to judge whether a low-priority project involving foreign loans deserves precedence over a high-priority project funded by the government. Third, projects involving foreign aid or foreign loans are evaluated according to methods peculiar to each institution. Criteria necessary for the actual evaluations differ from institution to institution, hindering any standardized comparison of evaluations. For this reason, the central government requires local governments to submit, in addition to evaluations conducted by individual institutions, basic information on each project set down in a government-prescribed format. For local governments, however, this requirement represents an undue burden.

Resolving these issues will require, first of all, complete coordination among 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, Department of International Cooperation of the Ministry of Foreign Affairs, and all other entities involved. It is important that these organizations build not only ties of cooperation, but also a relationship of checks and balances as each evaluates the others from its own particular viewpoint.

The decision-making process for public investment should serve the balanced development of the nation as a whole. All projects – whether funded by the government, grants, or loans – should be considered from the larger viewpoint of how best to correct the regional imbalances that now exist.

In the longer term, there is the question of how to deal with costs that accrue after a project's completion. Since this will become increasingly urgent as the number of projects grows, future maintenance and management costs must figure in even the initial decisions on whether to implement a project or not.

Chapter 5 Concluding remarks: from the viewpoint of "development coordination"

A country like Laos, surrounded by severe economic conditions, should pay more attention to "investment standard." This phrase covers social capability such as institutional development capability. On the other hand, considering that over a half of public investment is from foreign assistance, we should say that aid coordination and "development coordination" have to be concurrently implemented.

The meaning of this phrase, development coordination, is relatively broad. But we should not forget Laos is still at the initial development stage in economic terms. Government expenditure, as well as deficit, might contribute to the expansion of production activities in the long run. In that respect, efficient investment through coordination among government related organizations (including provincial governments) is significantly critical. It is recognized through the fact that national consensus is the key to investment allocation and appropriate investment standards, needed to make economic success stories at project level and sector level. Aid coordination, policy adjustment, and provincial initiatives should be discussed from the viewpoint mentioned above.

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3. Capital Raising by Issuing Government Securities

Panom LATHOUILY

Summary

In this study, I would like the authorities to understand the reality of the country and where its people, natural resources, economic situation, institutional constraints, strengths and weaknesses, and its opportunities and challenges stand at the moment. Therefore, I would like to remind the Lao authorities of past, current and prospective economic situations which are outlined as follows:

In chapter I, we discuss monetary management from the old economic mechanism to the new economic mechanism in the last twenty years. Chapter II is on fiscal management where we discuss about the evolution of the tax structures and tax management in the past twenty years. In chapter III, the evolution of government securities since 1990 is presented. How the government securities and Central Bank bills have played a very important role in fighting against inflation and in filling the gap of budget deficits. The potential for opting T-bills and T-bonds to develop the primary market which will lead to the development of a secondary market is also discussed. Chapter IV looks at how we can mobilize funds by issuing government securities and how we can turn government securities into an influential monetary instrument. We also talk about what can be done about the development of primary and secondary markets given the current environment of the Lao PDR, and the main thrusts of development of the Lao economy. In the final chapter, chapter V, we conclude by proposing six key policy recommendations:

1. **How can the financial sector be strengthened?**
2. **How can the public's confidence in the banking system and in Lao currency be increased?**
3. **How can the institutional arrangements of the foreign exchange rate be strengthened?**
4. **How can we strengthen the coordination between the BOL, MOF and Committee for Planning and Investment (CPI)?**
5. **How can the MOF be strengthened?**
6. **What can we do to develop the primary and secondary markets and to strengthen what already exists in the legal framework on commercial papers in the Lao PDR?**

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3. Capital Raising by Issuing Government Securities

Introduction

Lack of funds is a major problem for the government of the Lao PDR in implementing its yearly national economic and social development plan. As a result, the government has been trying to find ways to mobilize capital in a sustainable way to develop the country's physical and social infrastructure and its unexploited, rich natural resources. In general, funds can be mobilized through taxation, stock markets, financial markets, debt instruments and external savings. However, not every country can do this equally well without having macro-economic stability, a well functioning banking and financial sector, and a suitable environment. In other words, mobilizing funds is dependent on the amount of confidence the domestic and foreign investors have in the concerned country's economy.

How Much Confidence can be Created in the Lao Economy?

Confidence can be created in one's economy when people feel safe in their daily lives, in their day-to-day business transactions, in their existing and future investments, where macro-economic stability has been achieved for a long time, and where the local economy has little or no vulnerability to external problems or crises.

In Lao PDR, the majority of small to big business entrepreneurs have a very low level of education. As a result, their business minds are very simple, and so are their economic calculations. However, these entrepreneurs are very important stakeholders in the national economy since they have the choice whether or not to invest in the economy. We have to understand their business psychology, and try to apply rules and regulations which are acceptable and fair to them.

Most government officials were not educated systematically in a market-oriented environment, and one has to bear this in mind when trying to understand the Lao economy. Although the Lao People's Revolutionary Party and the Lao government have adopted a market-oriented economic policy since 1986, and there has been a lot of training to upgrade human resources to become familiar with this new economy, there is still a lot to be learned.

In a market-oriented economy, nobody can deny the importance of the government's role in economic management, in particular on the macro level, such as the maintenance of economic stability, the effectiveness of laws and regulations, and the efficiency of government institutions. On the micro level of developing infrastructure, such as road construction, electric power generation, building schools and hospitals, where the private sector is not interested or is not willing to risk investment, the government still plays very important role.

Macroeconomic Management

For macroeconomic management in the case of Lao PDR, there are things that need to be addressed from the perspective of time, from short to long term. Limited resources need to be well organized and allocated in order to be as efficient as possible. The government is currently facing many institutional constraints, but these have to be solved step by step taking into account their degree of urgency because it's the Lao people who best understand their own problems. In addition, in many instances it is not necessary to have sophisticated tools, but rather workable ones.

Division of responsibility needs to be spelt out for those who are concerned with macroeconomic management, such as the Committee for Planning and Investment (CPI), the Ministry of Finance (MOF), the Bank of the Lao PDR (BOL) as well as other Economic Ministries. Then a proper and practical coordination mechanism needs to be established to make information flow between them. Strong and influential persons still play a major role in macroeconomic management while very skillful, dedicated and courageous technocrats are the key to getting things done successfully.

Once proper organization has been established, then correct policy measures have to be applied, taking into account how much people will react to these measures at the current stage of the market development of the country. Perhaps measures need to be placed one or two steps above the average person's understanding in order to motivate them to work. However, if measures are too advanced for them, they will not understand them and consequently will not participate in the process. When we are aiming at sustainable economic stability in an environment where people properly understand the rules and regulations of the country, and their rights, duties and responsibilities, and where there are few institutional constraints, then it will not be too difficult to achieve any targeted economic goal.

Physical and social infrastructure development by the government needs to work hand in hand with the maintenance of economic stability. This is where the art of management and development comes in. In other words, it is necessary to look at how much growth and how much stability one wants to achieve and if it can be achieved at this stage of economic development while taking into account the various resources one has available.

Most least developed and some developing countries have more obstacles and more difficulties than developed countries in managing their economy because demand is always greater than supply. Sometimes, many least and developing countries follow a vicious cycle in pursuing their economic policies. This was true for Laos from 1988 to 1989, in 1995, and from 1997 to mid-1999. Each event greatly affected the Lao economy and the Lao currency, as the kip depreciated immensely during those periods. Only after the government took strong measures to tighten monetary and fiscal policies, together with other measures, did inflation go down, the exchange rate become stable, and economic stability was regained.

Impact of Money Supply (M2) on Inflation

In 1989, the growth of M2 was 89.3 percent due to an increase in net foreign assets of 12.4 times compared to 1988. Private sector lending shared only 3.7 percent of total lending to the non-government sector.

From 1990-94, the average M2 growth was 33.81 percent due to an increase in the average of net foreign assets. Throughout the period from 1995 to 2003, the average M2 growth was 45.86 percent. The average lending growth to the private sector was 25.07 percent between 1990 and 1994, and around 44.87 percent between 1995 and 2003. The loan to deposit ratio has been shrinking since 1997 due to the spill-over of the Asian financial crisis and the mismanagement of state-owned commercial banks whose total deposits share is as high as 80 percent of the Lao banking deposits (on 31 December 1999, the total deposits amounted to 1.9 trillion kip, equivalent to US$247 million). As of the end of December 2003, the outstanding loan to deposit ratio in the banking system is estimated to be about 30 percent. This means that 70 percent of the total liquid assets have remained unused for a number of years, becoming one of the major factors in causing losses to all state-owned banks.

The increase of excess liquidity in the financial system from 1994 to early 1995 contributed to a sharp increase in aggregate demand pressure, leading to a rapid increase in consumer prices from mid-1995. This increased the annual average inflation rate from 6.8 percent in 1994 to 19.4 in 1995, and strong import demand caused exchange rate instability from mid-1995. However, overall GDP growth continued to be robust at 7.1 percent.

In 1996, tight monetary and fiscal policies were successful in stemming inflation to about 7.3 percent by the end of the year. Real GDP growth remained strong at 6.8 percent although the country faced two consecutive floods which had considerable impact on agricultural production.

During 1997, average annual inflation increased to 29 percent due to substantial depreciation of the kip, and highly volatile rice prices in several provinces affected the overall consumer price index. Monetary measures were used to tighten credit growth through a combination of moral suasion and primary market operations based on treasury and Central Bank bills.

The monetization of the economy has been very low and the dollarization (the use and store of foreign currencies) has remained very high. These two factors have limited the effectiveness of monetary and exchange rate policies. Between 1990 and 2004, the financial deepening (M2/GDP) stood between 10 to 18 percent while the share of foreign currency deposits fluctuated between 30 and 85 percent of total liquidity. During the Asian crisis period, the dollarization went up as high as 85 percent mainly due to the depreciation of the kip. As recently as the end of December 2003, the ratio of foreign currency to total deposits slowly dropped to 70 percent.

Interest Rate and Price

The Central Bank of the Lao PDR has gradually liberalized the interest rates of the banking sector from strict control since 1990. In July 1993, most of the interest controls were removed, with only minimum saving deposit rates and maximum lending rates remaining. Two years later, the maximum lending rate was removed and in January 1996 the minimum saving deposit rate was lifted resulting in the full liberalization of interest rates, except agriculture-related interest rates. However, the banks did not actively respond to adjusting their rates due to lack of competition and the country's relatively closed economy.

After a decade of structural reforms, quite a number of economic features have been changed. Most prices are now determined by the market, and the trade and payment systems have been largely liberalized. Since the far reaching restructuring of the state-owned banks in 2001, banks have begun to be more aggressive in adjusting their interest rates to be compatible with internal and external economic situations.

Public Finance

During the period of 1985-89, there were fundamental fiscal reforms to improve the revenue of the government, which moved from almost complete dependence on non-tax revenue to primary reliance on tax revenue. The introduction of a comprehensive tax reform in 1988, which replaced transfers of public enterprises with profit tax, led to a sharp increase in tax revenue from 1988 to 1994. Expenditure increased sharply in 1988 due to depreciation of the official exchange rate and an increase of the wage bill. In 1989, there was a decrease in the overall deficit from 21.5 percent to 16.7 percent. The large deficits of 1988 and 1989 were offset by the inflow of foreign capital from multilateral and bilateral credits and grants to support the economic reforms of the government.

Though revenue/GDP ratios remain low, prudent fiscal policies have yielded in the current fiscal balance (excluding grants), which has been in surplus since 1992. The overall fiscal deficit decreased from 20 percent of the GDP in 1988 to less than 9 percent in 1995/96. Since the government has had credible policies in economic development, it has been able to get foreign aid financing for most capital spending and has been able to reduce its domestic debt.

Financial System in the Lao PDR as of the End of December 2004

The present financial system of the Lao PDR is composed of the following 8 institutions and groups:

1. The Bank of the Lao PDR which is the Central Bank of the country. It has a Board of Governors, Governor, one Deputy Governor and 9 departments.
2. The commercial banks are composed of three state-owned commercial banks (including Agriculture Promotion Bank), three joint-venture banks, six foreign branches of commercial banks and one representative office of a foreign bank.
3. Postal office savings institution which has been recently established.
4. Pawn shops which have been recently licensed to operate.
5. Credit co-operatives.
6. Depositors' protection fund which is also newly established.
7. One insurance company which is a joint-venture between the government and a French investor.
8. People's savings groups.

Therefore, in this study, I would like to make authorities of the Lao PDR aware of past, current and prospective economic situations, which are outlined as follows:

In chapter I, we discuss monetary management from the old economic mechanism to the new economic mechanism in the last twenty years. Chapter II is on fiscal management where we discuss about the evolution of the tax structures and tax management in the past twenty years. In chapter III, the evolution of government securities since 1990 is presented. How the government securities and Central Bank bills have played a very important role in fighting against inflation and in filling the gap of budget deficits. The potential for opting T-bills and T-bonds to develop the primary market which will lead to the development of a secondary market is also discussed. Chapter IV looks at how we can mobilize funds by issuing government securities and how we can turn government securities into an influential monetary instrument. We also talk about what can be done about the development of primary and secondary markets given the current environment of the Lao PDR, and the main thrusts of development of the Lao economy. In the final chapter, chapter V, we conclude by proposing six key policy recommendations.

CHAPTER I
Monetary Management

Role of the State Bank of Lao PDR during the Old Economic Mechanism in Managing the Money Supply:

Prior to the financial sector reforms in March 1988, there was only a mono-bank system in Lao PDR. It was called the State Bank of Lao PDR and it carried out both commercial banks' functions and the Central Bank's functions. The bank had its headquarters in Vientiane where it had two branches, and also had 17 provincial branches and 96 district branches around the country. But this mono-bank system failed to mobilize funds from the public because the banks' deposit rates were usually inappropriate compared to the inflation rate. The loan rates were usually too low for the banks to make any profit and the loans were focused on state activities and cooperatives such as lending to the SOEs, state farms, and commercial cooperatives whose performances were usually poor and many of which failed to pay back their loans on time. Therefore, it is obvious that both loans and deposit rates were strictly controlled by the government during that time. Moreover, all state banks also acted as government treasuries, transferring funds from the central budget to the provincial and district levels, making advances to the state organizations, and playing a non-active role in the economy. These consequences were the product of a centrally planned economy.

Policy Reforms in the Banking System

Realizing that the economic situation and well-being of the people could not be improved without reforming the monetary and banking sectors, the government decided to institute financial sector reforms, and of the banking sector in particular. The reforms started after the government issued Decree No. 11 of March 1988 which provided the legal framework for state-owned banks to function in a more businesslike manner. The main themes in this decree were to separate the Central Banking functions from the commercial banking functions in order to create a two-tier banking system; to turn all state bank branches into autonomous state-owned commercial banks or branches of another state-owned commercial bank, or to be dissolved; to give discretion to those state-owned commercial banks to decide on day to day operations; and to remove large pricing differentials between cash, bank drafts, bank balances and transferred money.

In order to support this financial reform, the government issued three more decrees in July 1989, the first of which was Decree No. 49 on Interest Rate Policy of Banks. The important points of this decree were (i) interest rates would be higher than the inflation rate; (ii) lending rates would be higher than deposit rates and (iii) long term rates would be higher than short term rates. The second one was Decree No. 50 on Credit Policy of Banks toward Social and Economic Base of the Country, which stipulated that the credit policy of commercial banks must treat every economic and social sector of the country on equal footing. The third one was Decree No. 58 on Management of the Exchange Rate between the Kip and Foreign Currency, and provided for the unification of the exchange rate. Prior to this decree, the multi-currency practice and multi-exchange rate system prevailed.

In response to the new financial policy, in August 1989, four regulations were issued by the Governor of the Central Bank, two of which were concerned about the interest rate schedules and the other two about checks. Although for both banks, loan and deposit rates were set more appropriately compared to the current inflation rate, the rates were rigidly set in a very detailed schedule by the Central Bank. From these actions we can see that the effective instruments the Central Bank used in controlling the money supply at that time were (i) positive and appropriately high interest rates and (ii) strict control over lending to state owned enterprises and the public sector.

In July 1991, commercial banks were given more flexibility to set their own rates when the Central Bank issued new guidelines that fixed only minimum and maximum rates for the loans to different economic sectors. In November of the same year, the guidelines were modified by stipulating only minimum rates. In August 1993, most rates in the guidelines were removed, leaving only a minimum savings rate and a maximum loan rate. The most recent modification was in July 1995 when the maximum interest rate of the banks' loans was removed (except for agriculture). The full interest rate liberalization was realized in January 1996 when the minimum deposit rate was lifted.

As for the credit to the SOEs, during the period prior to 1988, all SOEs enjoyed very cheap loans in running their businesses, but most of the time, the banks could not respond to their full requests due to lack of capital. After the banking reform in March 1988, all banks started to increase both loan and deposit rates with the spread being set at more than 10 percent. Quantitative controls were also applied to SOEs and as a result, many SOEs had to stop borrowing from the banks. Inefficient SOEs had to strive to survive, but many failed and had to be disposed of annually in different forms.

The monetary management was also strengthened when the Central Bank adopted some monetary policy instruments. These included a reserve requirement ratio of 5 percent of total deposit liabilities in October 1990, and a credit window to meet the short-term liquidity requirements of banks, as opposed to the extension of long term loans, in 1991. A small amount of short term Central Bank securities was issued from November 1991 to November 1993 to familiarize the commercial banks with this financial instrument. The Central Bank could use these securities with the objective of removing excess liquidity from the financial system when necessary.

Structural Reform of the Banking System

In addition to policy reforms, structural reforms of the banking system were also carried out. These followed the government's announcement to transfer autonomy to state-owned commercial banks that remained under state jurisdiction while others had to be liquidated. In October 1988, two state-owned commercial banks in Vientiane capital were granted the autonomy to run their business, followed by the biggest commercial bank of Lao PDR, the BCEL (Banque Pour Le Commerce Exterieur Lao) in November 1989. By the end of September 1991, the program of transferring autonomy to three commercial banks in Vientiane capital and four state-owned regional commercial banks was completed, accomplishing the two-tier banking system in Lao PDR.

In June 1990, the Central Bank was formally created out of the State Bank of Lao PDR by Law No. 4, and was formally named The Bank of the Lao PDR. This law, which was amended in October 1995 and again in October 1999, dictates the rights and duties of the Central Bank to achieve two main objectives: (1) "promote and maintain internal and external monetary stability, an efficient payments mechanism and the liquidity, solvency and proper functioning of a soundly based monetary, credit and financial system in Lao PDR" and (2) "foster conditions conducive to orderly, balanced and sustained economic growth for the prosperity of the Lao people". In addition, the law entrusted the Central Bank with the management of foreign reserves, empowering it with more market-based monetary management control. This was followed by a series of banking decrees including Decree No. 53 of September 1990 (replaced by Decree Law No.1 of 9 August 2002) on The Management of Foreign Exchange and Precious Metals, Decree No. 3 of January 1992 (replaced by Decree Law No. 01 of 11 March 1997 and subsequently replaced by Decree Law No. 02 of 22 March 2000) on The Management and the Operations of the Commercial Banks and Other Financial Institutions. Only the Bank of the Lao PDR is authorized to grant or refuse a license to an applicant for establishing a bank or financial institution.

As for the participation of the private sector in the financial market, in October 1989, the government allowed, for the first time, a private bank to be established in the form of a joint venture with the government holding 30 percent of total shares and foreigners owning 70 percent. It was also the first time state commercial banks felt they faced a real competitor. Seven years later, six Thai bank branches (Thai Farmers Bank' branch voluntarily closed their operations in 2003), one Malaysian bank branch, one Standard Chartered Bank representative's office and one locally incorporated bank were licensed to open and operate in Vientiane capital. This policy is to develop the financial markets in Lao PDR, so as to ensure the availability of credit and provide more choices for the public.

In June 1990, The Lao Bankers' Clearing House started operation in Vientiane with five charter members, including the Bank of the Lao PDR, BCEL, Nakhoneluang Bank, Sethathirath Bank, and the Joint Development Bank. Six years later, nine more banks joined (Vientiane Commercial Bank, Siam

Commercial Bank, Thai Military Bank, Thai Farmers Bank, Agricultural Promotion Bank, Bangkok Bank, Krung Thai Bank, Bank of Ayoudhya, Berhard Public Bank and Standard Chartered Bank). Four regional banks, namely Lao May Bank, Phak Tai Bank, Aloun Mai Bank and Lane Xang Bank have been represented by the Bank of the Lao PDR.

By the end of 2004, the commercial bank system was composed of three state-owned commercial banks, namely the BCEL, the Lao Development Bank (after the merging of Nakhoneluang Bank, Sethathirath Bank Lao May Bank, Phak Tai Bank, Aloun Mai Bank and Lane Xang Bank) and the Agriculture Promotion Bank; three joint-venture banks; six foreign branches and one representative office of a foreign bank operating under the rules and regulations of the Bank of the Lao PDR.

External Assistance in the Banking Sector

From the period between 1989 and 1994, the government was given a soft loan by the International Food and Agriculture Development (IFAD) of about US$4.4 million with 0.5 percent interest rate and 40 years maturity. This loan was intended for agricultural, agro-industrial and handicrafts projects at a very low interest rate of about 7 to 8 percent per annum for all qualified clients. Another soft loan at a similar interest rate and maturity was the industrial credit line of about US$10 million from the Development Association (IDA) of World Bank group from 1989 to 1994. This project aimed to give credits mainly to rehabilitate or increase the capacity of production of existing manufacturing firms, and for some new industrial and service projects both in the public and private sector at a very low interest rate of about 7 to 8 percent per annum. The third soft loan of US$3 million (allocated from the US$25.0 million financial sector program loan from ADB) was for non-agricultural projects between 1990 and 1994, with interest rates varying from 12 to 16 percent per annum, and with at least 60 percent to be in the non-state sector. All these funds have established a facility of long term credit in the banking system to create capital in the economy, which most banks currently cannot do by themselves.

By the end of 1994, the overdue state-owned bank loans equivalent to about US$15 million from before the banking reform period were completely refinanced by the Ministry of Finance through government bonds maturing from one to 10 years. In addition, about US$5.5 million out of the US$25 million financial sector program loan from ADB was allocated to recapitalize the seven state-owned commercial banks in 1994 so as to establish the 8 percent of risk weighted assets for these banks.

Furthermore, since 1989 the government has obtained a number of program loans from international institutions, such as the International Monetary Fund (IMF), International Development Association (IDA) of the World Bank and the Asian Development Bank (ADB), with a concessional interest rate for the improvement, strengthening, institutionalizing and restructuring of the macroeconomic framework and policies of the government.

For instance, the Structural Adjustment Facility was a medium term program with SDR 22 million (about US$29 million) for three years which was approved in September 1989 by the IMF Board of Directors. In this program, a number of monetary, fiscal and external policies, targets, benchmarks and criteria were set for each year and were agreed upon by the government to implement. The program helped stabilize the economy by reducing the rate of inflation to the rate prevailing in trading partner countries by 1992. By the end of December 1992, the inflation rate was only 6 percent, slightly more than Thailand. An average real GDP growth from 1990-92 of 5.9 percent was also achieved, therefore meeting the 5-6 percent target set by the IMF.

The first Structural Adjustment Credit or SACI was approved by the IDA executive directors in June 1989, another soft loan of SDR 30.0 million (US$40 million) to the Lao government. It was loaned on standard IDA terms with 40 years maturity to support the government's structural adjustment program for the period between 1991 and 93. Again, a number of conditions were set by the World Bank, which the Lao government agreed to carry out. One of these conditions, on financial sector development, was fully observed when the single multi-purpose State Bank of Laos was transformed into a Central Bank (the Bank of the Lao PDR) and its former branches were restructured into seven autonomous commercial banks. Interest rates were increased to appropriate levels and their structure was rationalized so as to eliminate subsidies.

Another agreement, the first Financial Sector Program Loan from ADB of SDR 17.424 million (US$25 million) was signed between the ADB and the Lao government in December 1990. This was another soft loan with 40 years maturity and a 10-year grace period, which aimed to support the financial sector of Lao PDR, identify policy initiatives and reforms, strengthen institutions, and promote private sector development and privatization of SOEs. The institution of this loan was concluded in October 1994 with most of the conditions being fully observed, some substantially observed and a few partially observed. Some of the main achievements under this loan were the full creation of a two-tier banking system, and the recapitalization of the non-performing assets of the seven state-owned commercial banks, which could not be repaid by the former SOEs and commercial cooperatives until they became autonomous. Their capital adequacy was raised to the level of 8 percent of total risk weighted assets, a level in line with the Basle standard for the capital adequacy of the international commercial banks.

The second Structural Adjustment Credit or SAC II was approved by IDA's Executive Board of Directors in October 1991, and was another soft loan of SDR 30.0 million (US $40 million) with the same terms and same maturity as SAC I. This IDA credit was intended to support the consolidation of the comprehensive reforms undertaken by the government in the critical areas of (i) enterprise reform, focusing on privatization and private sector development; (ii) resource mobilization through revenue enhancing policy measures and administrative capacity building; and (iii) public resource management upgrading. This credit was used to finance part of the balance of the country's trade deficit at a time when the former Soviet Union was pulling out its aid.

In June 1993, another three-year program loan of SDR 35.19 million (about US$48.5 million) under Enhanced Structural Adjustment Facility (ESAF) was approved by the Board of Directors of the IMF. This program aimed to sustain growth, while lowering inflation and achieving a viable external position. In order to achieve those objectives, the Lao government, together with the IMF missions, worked out the benchmarks, criteria and targets for each year in monetary, fiscal and external policies. At the end of 1995, SDR 23.466 million or US $32.3 million had already been disbursed. During the second and third quarters of 1995, Lao PDR's economic performance was characterized by increasing demand pressures on domestic prices and the exchange rate. The government, together with the IMF missions, immediately worked out and adopted monetary and fiscal measures to tighten the money supply and to reduce the fiscal deficit in July 1995. As a result, inflation has been brought under control since the beginning of the fourth quarter of 1995 and the exchange rate has been stable at a rate of between 935 and 945 kip per one US dollar.

The funds and achievements under these programs contributed significantly to the economic stability during the 1990s. They particularly helped the Lao Banking system gain the public's confidence by creating a new legal framework for the financial sector, institutionalizing a two-tier banking system, and by introducing new financial instruments, such as T-bills and Central Bank bills, for future indirect monetary control. In addition, they have established a reserve requirement ratio, a clearing house and discount window which accepts T-bills and Central Bank bills to increase the liquidity of those financial instruments, regular auctions of T-bills, and have gradually liberalized the interest rate since July 1993. These initiatives aimed to prepare the Lao financial sector for the next stage of market economy development in the 2000s.

New Role and Degree of Central Bank Independence in Determining Money Supply

Currently, the Central Bank of Lao PDR has a mandate equivalent to ministry status. Its role is to assist the government in maintaining the stability of the domestic currency and keep inflation low for the country. What is different from other ministries is that it has a Board of Governors which is comprised of 7 to 9 members with the Deputy Prime Minister as its Chairman, the Governor of the Bank of Lao PDR and Minister of Finance as co-Vice Chairman, and a Deputy Governor and 3 to 5 other members from various sectors of the national economy who are appointed by the Prime Minister.

The Board of Governors is the supreme policy making organ of the Central Bank in determining money supply, credit policies and the policies of banking supervision while day- to-day operations are left to the Governor and Deputy Governors.

Coordination Mechanisms between the Bank of the Lao PDR and the Ministry of Finance and other Formal Institutions

At the policy level, the coordination channels between the Bank of the Lao PDR and the Ministry of Finance are quite clear since the Minister of Finance is a *de facto* Vice Chairman of the Board and the Board meets at least once every two months. Therefore, at the policy level, the Central Bank and the Ministry of Finance should understand each other's position and main policies. At the executing level, dynamic interactions between the two organizations need to be established, for example, on how to bring inflation down, stimulate employment, and stabilize the exchange rate. At present, there isn't really any joint-committee that conducts regular discussions on technical matters.

As for the means which enable the Central Bank to coordinate its activities with other formal institutions, in March 1995 the Central Bank set up a bankers' association which meets on a monthly basis and reports to the Governor of the Central Bank. The Governor, in turn, can inform them about new financial policies through their presidents. In the state-owned commercial banks in Vientiane Prefecture, the managing directors or their representatives report the week's salient events at the Central Bank's weekly meeting, which all directors or representatives of the departments also attend. No links have been established so far with the informal financial institutions, but considering that these institutions, particularly the credit circles or tantines, are quite popular and prevalent, it is advisable that the Central Bank studies them and makes recommendations on how to get the participants in line with the banking system, and connected with the Central Bank..

The monetary system has improved significantly since the government decided to launch the New Economic Mechanism Policy in 1986. However, the latest monetary indicators, such as the money term structure (M0/M2* is equal to 24 percent while in a sound economy it is only 15 percent or less) and the financial deepening (M2/GDP is equal to only about 10 to 18 percent while in a sound economy it is between 24 and 100 percent) still show that the Lao banking system is at an early stage of development. Many areas, particularly the institutional and human resource constraints, need to be strengthened and developed to further gain confidence from the public.

* M0= currency outside banks
M1= M0 + demand deposits
M2= M1 + time and savings deposits + foreign currency deposits.

CHAPTER II
Fiscal management

Development of Responsible Institutions for Public Finance

The role of public finance can be categorized into the following three main periods:

(1) 1950 to 1975 – Identified as the period of national and democratic revolution when public finance was concentrated on the tasks of battlefields.

(2) 1976 to 1985 – Identified as the period when public finance went to repair the wounds of war and to construct the national economy and society during the first stage of liberalization. Public finance originated mainly from external sources, particularly the former Socialist Block. But towards the end of the period, domestic financing covered 54 percent of the total revenue, whereas 46 percent came from external sources.

(3) 1986 to present – Identified as the period of finance of the New Economic Mechanism. During this period, the tax system has been revised and tax collection has improved year after year. The functions of the Ministry of Finance are to manage and exploit state revenue, to manage state expenditures, to be more efficient, and to restrict inflation. More recently, attention has focused on the coordination between the Central Bank, the Ministry of Trade and the Committee for Planning and Investment to prevent and control potential inflation.

Tax Structures and Development of Taxation Policies

Prior to 1988, the major part of government revenue came from non-tax revenue while tax revenue came largely from a few major types of taxes namely turnover tax, import and export tariffs. The non-tax revenue was generated from public enterprises whose revenue and expenditures were closely monitored by the government, whose majority of profits were directly transferred to the state budget, and whose losses were taken care of by the state. Decree No. 9 on State Tax Policy was issued in March 1988, stipulating fundamental fiscal reform for the first time. Previously, public and private enterprises were taxed differently with the private sector being taxed more heavily. Under the comprehensive tax reform, taxes were uniformly collected by the state for the first time. Decree No. 9 introduced new tax policies that stipulated that all business entities, whether state-owned or privately owned, be taxed equally. This decree also introduced the following series of taxes (and their structures) that are collected in the market economy:

- Tax on agricultural commodity;
- Export and import tariffs;
- Income tax including personal income tax and profit tax of enterprises;
- Turnover tax.

The tax structure on profits from manufacturing enterprises were composed of 8 bands with the highest being 85 percent for the production of beer, soft drink and cigarettes. The lowest band of 20 percent is for rice milling and salt production. After applying these eight bands of profit tax, those paying on the higher side complained that the government was giving opportunities to inefficient enterprises to survive in the economy while efficient ones were being taken advantage of. As a result, in June 1989, the tax structure on profits was simplified to two bands under Decree No. 47, with all types of business paying 45 percent, and banking businesses paying 60 percent. The profit tax on foreign owned enterprises in Lao PDR was subject to the rates stipulated in the (former) Law on Foreign Investment of 1988. The Law had as many as six bands, ranging from 20 percent for road and bridge constructions and agricultural projects, to as high as 50 percent for trade, banking and insurance businesses, and the tax holiday ranged from two to four years. This law was amended in March 1994, making the profit tax a flat rate of 20 percent for all types of business and ending the tax holiday for new foreign investment projects.

The personal income tax was stipulated for the first time in 1988 under Decree No. 9 which aimed mainly to tax those people employed by international organizations and foreign owned enterprises whose salaries were much higher than government employees. But there was only one rate for those whose salaries or wages were more than 15,000 kip. During that time, the minimum and maximum wage brackets for government employees were 2,000 kip/month and 10,000 kip/month respectively. The personal income tax was also modified in Decree No. 47 of June 1989 and was categorized as follows:

(1) Dividend tax from equity shares was subject to 10 percent taxation; (a) earning from rental assets and capital gains (except from bank interests), subject to 40 percent taxation, and in 1991 was modified to 30 percent; (b) earning from undertaking liberal profession, subject to 25 percent taxation; (c) earning from personal trading was progressively taxed from 10 percent to 40 percent depending on the range of earning of less than 200,000 kip and more than 4,000,001 kip respectively; (d) earning from wages and salaries to be subject to progressive taxation from a minimum of 2 percent to a maximum of 30 percent with the salary range of 25,000 kip and below to 300,001 kip and up respectively and exemption was given for those who earned less than 15,001 kip per month. The taxes on income were modified in Decree No. 12 in February 1991 with a maximum taxation of 45 percent for those earning more than 5 million kip per month. The most recent change was made in Tax Law No. 4 in October 1995.

(2) In Decree No. 9 in 1988, the eight band turnover tax was applied to handicrafts, construction, transportation, retail trade, workshops or repair services, and hotels and restaurants ranging from a minimum of 1 percent for road and irrigation rehabilitations to a maximum of 15 percent for high quality restaurants and night clubs. It was found that there were too many bands which were not very encompassing and were too difficult for the tax authorities to levy. As a result, some change was made in the tax decree of June 1989 by reducing the eight band turnover tax to five bands stipulating the four types of activities that were subject to turnover tax: imported goods, wholesale of local producers,

wholesale of imported goods by importers and other services business. To make tax collection more convenient, these five bands were then decreased to two bands of 5 percent and 10 percent in the modification decree in 1991. In Tax Law No. 4 of October 1995, a system of four bands with a tax ranging from 3 to 15 percent was adopted.

(3) In Decree No. 9 of 1988, the agricultural commodity tax was stipulated. Paddy was taxed per hectare depending on the fertility of land, which was categorized by type (four for lowland areas and two for upland areas). Coffee, Cardamom, tea and tree fruits were taxed on annual income at a rate of 6 percent. Timber exploitation tax was levied in absolute value per cubic meter; for the special quality wood, the tax on its first category was 10, 000 kip per cubic meter, about 4.5 times more than other kinds of wood of the same category. The tax on the second category was 6,000 kip per cubic meter, 4 times more than other kinds of wood of the same category. Agricultural products, cattle and pigs were taxed at a rate of 6 percent of their sale price.

(4) In tax Decree No. 47 of June 1989, some modifications were made to lower the tax rates of most agricultural commodities. For example, there was a reduction of 20 kg/ha/year for each category of paddy harvest, except for the second category of paddy tax (upland) where the reduction was only 10 kg/ha/year. Tax on coffee, Cardamom, tea and agricultural products, cattle and pigs was reduced by 1 percent, while fruit tree tax was reduced by 3 percent. These reductions were intended to encourage farmers in their agricultural production. Also in Decree No. 47, tax on timber was extracted from the agricultural commodity tax, but was included in the natural resource royalty, a new tax introduced under this decree.

During March 1993, the government adopted two tax decrees to strengthen tax collection. In Decree No. 50 on Land Tax, paddy tax was dropped and farmers were taxed on the paddy field areas they owned instead. Decree No. 52 on Registration Tax created new kinds of revenue for the government through fees for registering documents or certifying ownership.

The tariff structure for exports and imports in Decree No. 9 of 1988 was made in the following manner:

- The profits from exported goods were taxed and those profits were defined as free on board (FOB) receipts minus the cost of production which included transport, packaging, and losses. There were six categories of tax rates ranging from a maximum of 80 percent for electricity export and strategic goods which were not processed, to no tax at all for re-exported goods.

- Import tariffs were composed of 13 bands. Tax was exempted on goods exported or imported to pay debt, goods imported as grants, goods imported under an investment project and goods imported for sample. One percent tariff was placed on machinery, transport equipment and spare parts for heavy industry, agriculture, forestry, irrigation, construction, telecommunications, salt production, insecticides, pesticides and animal feed. A maximum tariff of 60-70 percent was collected for cars, beer, alcohol, soap, packaged cigarettes, cigars, concentrated sugar and gambling equipment. In the most recent Customs Law adopted in July 1994, there remain only 6 main bands ranging from 5 to 40 percent for the normal goods. Luxury items such as beer, cigarettes, and vehicles have duties of 60 percent, 60 percent and 150 percent respectively. The government also abrogated the power of ministries and provincial authorities to grant discretionary exemptions on import duties.

In Decree No. 47 of June 1989, the export tax was dropped except for those goods sent by the post office, which were taxed at a rate of 2 percent of their value up to 100,000 kip per time and 5 percent of the value of more than 100,000 kip up to 400,000 kip per time. As for import tariffs, some rates were adjusted and more goods were added to the list of imported goods. Rates were further adjusted in modification decree No.12 in February 1991 to be compatible with the situation.

The natural resource royalty was first introduced in the government taxation in policy in June 1989. Its objective was to better manage the exploitation of natural resources, expand the foreign trade, protect the environment, and keep the country's nature in balance. The tax rates were composed of the following six categories:

(1) Metal mineral resources;
(2) Non-metal mineral resources;
(3) Mineral resources which can be processed into construction materials;
(4) Fuel mineral resources;
(5) Land concession for development;
(6) Timber, agricultural and forest products.

According to Article 18 of Law on Foreign Investment of March 1994, all the rates of the above six categories can be negotiated between the government and the foreign investors for special cases such as large projects or projects which the government considers high priorities for the development of the country.

In the timber, agricultural and forest products category, there were three kinds of tax, including a reforestation tax, timber tax, and a special tax, or tax on logs and timber which were exported. In April 1990, the timber royalties were modified by Decree No. 23 to be more compatible with the government's policy of reforestation and restrictions on exporting logs.

Excise duties on consumption were created for the first time in Decree No. 13 in February 1991 on petroleum products and some luxury goods such as imported alcohol and tobacco in value per one unit of each item. In December 1994, some amendments were made to increase the rates of these excise duties and the most recent change was made in the Tax Law of October 1995, but the rates are in percentage rather than in amount.

Decree No. 14 in February 1991 on minimum corporate income was adopted to require every enterprise to pay a minimum tax of two percent of turnover whether it makes profit or not, and covered those trying to forge account bookkeeping. If the financial statement was shown to be profitable at the end of the year, this minimum corporate tax would be counted as already paid as part of the profit tax and the remaining profit tax would be submitted to the tax authorities. However, this tax was not implemented until January 1993 when Decree No. 4 was issued with a lower rate of 1.5 percent. The latest change of .5 percent was made in the Tax Law in October 1995.

During 1994, two laws and three decrees concerning the responsibility of the Ministry of Finance were adopted. These were the Budget Law, Customs Law, the presidential decree on a uniform system of nomenclature of goods and import tariff rates, a decree on road user fees, and a decree on amendments to the excise tax on consumption of strategic goods and luxurious goods. In October 1995, the National Assembly adopted the Tax Law which compiled all the tax decrees and regulations previously promulgated, with some revisions on turnover tax, excise tax on consumption, profit tax, withholding tax and minimum profit tax. One of the important changes was on the profit tax which was reduced from 60 percent for the banks and 45 percent for other types of business to a single rate of 35 percent for all types of business in order to promote local entrepreneurs and traders. This law also promotes investment projects in the government's priority areas, for example, if a project is located in an urban area, the profit tax is 20 percent, whereas if it's in the rural and low land area, the profit tax is 15 percent. In rural and mountainous areas, the profit tax is only 10 percent. These legal frameworks have upgraded, complemented, replaced or amended previous decrees in order to strengthen fiscal management.

Since 1992, the government budget has been unified, encompassing all revenues and expenditures nationwide. With the new fiscal policy and with additional and improved tax measures for tax collection since 1988, the ratio of tax revenue for the GDP increased from 6.4 percent in 1989 to 7.5 percent in 1991 and 12 percent in fiscal year 1994/95. The rate has stagnated around this level to date. Nonetheless, this improvement is still very small compared to other developing countries, so it is important that the government makes a greater effort at tax collection. Although tax collection measures have been developed and refined so far, a more comprehensive legal framework for fiscal management is still needed for further economic reforms towards a market-oriented economy in Lao PDR. Previous shortcomings have been solved, but new shortcomings arise as the economy, and the private sector, grows.

Institutional Framework Available to Ensure Effective Tax Collection

In regards to institutional framework, the Ministry of Finance merged with the Committee for Planning in 1988 into the Ministry for Economic Planning and Finance. However, the merger was dismantled and divided back into the two ministries in 1993. The National Treasury was created in February of the same year in the Ministry of Finance with the sanctions to manage the state revenue and expenditure in accordance with the state budget.

In August 1990, the government issued Decree No. 40 establishing two separate departments, the Tax Department and the Customs Department, out of the Department of Tax and Customs and the Land & Property Tax Department. Their roles and functions were clearly defined and the main purpose of the decree was to strengthen the tax collecting organizations. In August 1991, the government adopted decree No. 68 on Centralization of Tax Collection and the fiscal year was changed from the calendar year to between October and September of the following year in order to improve fiscal management.

Since 1993, eleven departments have been created to implement fiscal policy and to carry out fiscal management in the new Ministry of Finance. Four departments, namely the Customs Department, the Tax Department, the State Property Management Department and the Land & Housing Management Department are responsible for raising revenue for the government. But there have been many constraints in tax collection and raising revenue for the state so far. The most serious are the lack of qualified staff to follow up on rules and regulations at the grassroots level, lack of modern equipment for monitoring and checking the traders, and an insufficient number of warehouses to store goods confiscated from smugglers. In addition, the consciousness of the people to pay taxes is still very low, and the enforcement of laws and orders is not very strict.

In February 1993, the National Treasury was set up in the Ministry of Finance. It is composed of four departments, including the Treasury Department, the Public Accounting Department, the External Finance Department and the Treasury Control Department. The main functions of the National Treasury are to manage the state revenue and expenditure, to organize and mobilize funds from domestic and external sources in order to meet the needs of the state budget, and to monitor and control the treasuries nationwide. Since the end of 1995, treasuries have been operating in all provinces.

In regards to expenditures of the budget, there are two main parts, namely the current expenditure and the capital expenditure. The process of preparing the budget for both revenue and expenditure for the fiscal year starts in June of the given year, with consultations and coordination being carried out between the Ministry of Finance and the Committee for Planning and Cooperation, the line ministries and the provincial authorities. For current expenditure, which is mainly composed of wages and salaries of public servants, operations and maintenance, debt service and transfers, the main decision-making responsibility lies with the Ministry of Finance after consultations and coordination with the concerned state organizations. Concerning capital expenditure, including productive and non-productive projects, the Committee for Planning and Investment makes the decision on what and how many projects will be implemented in the forthcoming fiscal year, taking into account the allocated budget for the fiscal year from the Ministry of Finance.

As for the formation of the national budget, after all the revenues and expenditures for the fiscal year have been compiled at the end of September, the budget is presented in the National Assembly in October for approval. Review of the national budget is carried out after six months of implementation during the mid-year session of the National Assembly.

In order to improve the management of state revenue and government spending, a treasury has been established in every province. Nevertheless, many things, including know-how of both hardware and software, need to be in place for them to carry out their proper functions.

Chapter III
The Evolution of Government Securities

The Unsystematic Use of T-bills and BOL Bills in Solving Financial Problems

In 1990, the government took a drastic measure to curb the nearly 90 percent inflation by issuing three month roll-over treasury certificates with a 48 percent annual interest rate from June to October. These certificates worth 2 billion kip were aimed at absorbing the excess liquidity in the market. From November 1990 to October 1991, as inflation decreased, the government reduced the annual interest rate to 42 percent.

Realizing the effectiveness of the instrument in bringing down inflation, the government allowed the Bank of the Lao PDR to develop its own monetary instruments with a total of 1.5 billion kip. Therefore, the first BOL bills with a six month maturity of 200 million kip were launched in November 1991. Seven consecutive issues ranging from 200 million kip to 400 million kip were released from January 1992 to November 1993. The interest of 24 percent per annum was given to the first six batches, a 20 percent interest rate was given to the seventh batch and a 15 percent interest rate was given to the last batch. In July 1992, the Ministry of Finance concurrently sold 2 billion kip treasury certificates with a three month maturity to the public through the state-owned banks. There was obvious evidence that the effective coordination between the MOF and BOL was insufficient during this period. However, the drop in inflation starting in 1989 was due to the successful absorption of the excess liquidity in the market and from then on, Lao PDR concurrently received large amounts of external assistance mainly from the IMF, World Bank and ADB under the macroeconomic reform support program loans.

The only legal framework to guarantee the treasury certificates during that time was an agreement between the MOF and BOL to repay the principal and the interest when falling due. The authority of the Central Bank to experiment with the new monetary instruments was provided under the Decision Notice of the Governor.

In 1994, after coordination with the Ministry of Finance, the BOL gave serious consideration to holding auctions of government securities. Since the Finance Ministry was willing to issue debt instruments to mobilize funds domestically and since negotiable bills were an effective instrument for open market operations, it was clearly in the interests of the Central Bank to support this process. The Ministry of Finance and the Central Bank reached an agreement on the allocation of T-bills to the Central Bank for the purpose of domestic funding to the budget.

A number of rules and regulations were prepared and promulgated by the BOL and a committee was organized to hold the first T-bill auction. In addition, meetings and seminars were held between the

BOL, MOF and commercial banks staff for the initial running of the auction.

The important legal framework for the auction was comprised of The Prime Minister's Decree No. 41 dated 5 March 1994 on the approval of T-bill sales to finance the budget deficit in 1994, the Governor's regulations on T-bill auctions, and the Governor's regulations on discounting the bills. Since then, whenever the MOF wants to raise funds from the public or commercial banks, or BOL wants to absorb the excess liquidity in the markets, they have to get approval from the government. Most of the time, the procedure of approval was too slow to meet the current need, due to administrative procedures. The first auction of T-bills was held on 10 March 1994. Since then a bi-weekly auction has been held among the state-owned and private commercial banks and on January 9, 1995 the new regulations on T-bill auctions were amended to include the non-banking sector in the auctions.

By the end of December 1995, the Central Bank had already carried out 39 auctions of Treasury bills with the outstanding amount of bills worth 6.4 billion kip. In June and August of 1995, a total of 15 billion kip worth of Central bills were issued to fight inflation for the first time. The May crisis of 1995 highlighted some of the effectiveness of indirect monetary instruments to the Lao authorities. But some constraints were also observed under the current financial system as some direct measures were still necessary to complement and support the indirect ones. This was because the open market operations in Lao PDR had just been introduced in the system; interest rates had been more or less liberalized since July 1995, but most banks were not familiar with active competition and still reacted very cautiously when making changes to their rates.

After June 1995, the BOL issued two batches of Central Bank bills totaling 15 billion kip aimed at absorbing the excess liquidity, a measure, which together with other monetary policy instruments, seemed to have worked. Monetary management was tight, and the exchange rate once again regained its stability although at a higher rate of 940 kip per one US dollar. During the last quarter of 1995, the inflation rate was reduced if compared month by month. In 1995, the kip depreciated by about 14.8 percent on average compared to 1994 and the monthly inflation rate ending in December 1995 was 25.6 percent.

The economic situation in 1996 was relatively stable. The kip depreciated only 5 percent for the whole year compared to both the US dollar and Thai baht and the annual average inflation was only 7.3 percent. That year, the Central Bank issued two batches of Central Bank bills. The first one was released on September 17 for the amount of five billion kip, with a six month maturity and 22 percent annual interest rate. The other one was released on December 29 for the amount of 13 billion kip with a six month maturity and three types of interest rate of 24 percent, 22 percent and 20 percent, to support budget financing.

From May 1997, inflation was going up and the exchange rate fluctuated strongly as it was in other Southeast Asian countries, including Thailand, which is one of the Lao PDR's major trading partners. In 1997, the kip depreciated 29 percent against the US dollar and 13 percent against the Thai baht compared to 1996. The year to year inflation from the month of May 1997 was rising. During this year, the authorities were very worried and confused about the regional crisis. The Central Bank did not issue any bills to absorb the excess liquidity and the Ministry of Finance was hesitant to sell its T-bills through the auction system because of high inflation.

From January 1997 to February 1998, the average bid for T-bills in the auction was about 2.25 billion kip. However, the amount of money and number of participating banks was thinning down towards the end of the period. The main reason was the spill-over of the Asian crisis to Lao PDR, which was the cause of inflation rising to three digits. The MOF decided to cap the interest rate at 20 percent for the auctioned T-bills in late 1997 and this discouraged many banks to bid. Since March 1998, the auction has not been very active and there has been no serious plan to revitalize it so far.

In the first three months of 1999, inflation remained high at between 150 to 167 percent and the exchange rate fluctuated very sharply with the kip in the parallel market depreciated by 25.0 percent. The commercial bank exchange rate, however, was suppressed to depreciate only 8 percent. Therefore, there was a very large difference between the commercial banks' rate and the parallel market rate. In January, the difference was about 21.4 percent and in March about 48 percent. The Central Bank was given the green light by the government in January 1999 to issue high incentive certificates of deposit at a 60 percent annual interest rate. The first batch was issued with an amount of 50 billion kip on April 1 with a six month maturity and the second batch was issued with an amount of 90 billion kip on October 27 with the same maturity. These high interest rate bills were quickly bought out by the general public and were rolling over with the lower interest rates as the inflation rate was coming down. The third batch of central bills was released on December 6 worth a total of 50 billion kip, a six month maturity and a 48 percent annual interest rate. One may wonder why the people were buying these bills whose real interest rate was lower than the inflation rate at the time. The simple answer is that they had no better alternative to invest their money.

Capital Market Potential in Lao PDR

As mentioned earlier, most banks' deposits in Lao PDR at the moment are short term (less than one year), so there is little capital market played by the commercial banks. Besides, financial institutions which deal with long term loans hardly exist. There is only one specialized bank, the Agricultural Promotion Bank, dealing with long term credit with agricultural and forestry projects supported by soft loans from international organizations. A long term credit fund, the CFD (Caisse Francaise pour le Development) extends long term loans up to a maximum of US $100,000 to small entrepreneurs.

At present, there is neither a stock exchange nor securities companies, although the business law of July 1994 allows public limited companies to raise capital by issuing shares and bonds to the public.

Looking back, the primary market for Treasury bills came from three sources. The first was the auction that was held every two weeks from March 1994 to February 1998. In the auction, two types of bids could be tendered for T-bills: a competitive bid and non-competitive bid and the minimum denomination of T-bill was 10,000,000 kip. The second source was the new issues of T-bills in each period of the MOF and of the BOL. The third were the Central Bank bills issued by the BOL. However, those bills hardly created a secondary market, except in the early period of auctioning. The outstanding T-bills to date are about 96 billion kip, that is, less than 1 percent of the GDP. In other developing countries of ASEAN, the percentage of T-bills to the GDP in the primary market is as follows: Thailand: 24 percent; Malaysia: 37 percent.

In 1994, there was a small and limited primary market for Treasury notes when the MOF recapitalized the seven state-owned commercial banks by non-negotiable Treasury notes equivalent to US$15.0 million. These had different maturities ranging from one year to ten years with an interest rate of 6 to 7 percent per year and paid every six months. In 2003, the MOF once again issued the Treasury notes to pay its triangular debt. These Treasury notes have one to three year maturities with an interest rate of 11 percent per year and paid every six months. They are limited negotiable, which means that the MOF issued the T-notes to pay their debts to the private companies that carried out the government projects, and then these private companies use T-notes to repay the concerned commercial banks. It is estimated that the total amount is about 360 billion Kip which is less than 3 percent of the GDP.

The sale of T-bills from December 1990 to November 2004 by the Ministry of Finance:

Year of issuing	Maturity	Interest rate per year	Total amount (kip)
Dec-90	3 months	48% and 42%	7,000,000,000
Dec-91	6 months	36%	10,000,000,000
Dec-92	6 months	36%	12,000,000,000
Dec-93	6 months	36%	12,000,000,000
Dec-94	6 and 12 months	13% to 15%	23,000,000,000
Dec-95	6 and 12 months	16% to 30%	18,360,000,000
Dec-96	6 and 12 months	24% to 26%	46,000,000,000
Dec-97	6 and 12 months	19% to 23.5%	52,700,000,000
Dec-98	6 and 12 months	19% to 23.5%	50,700,000,000
Dec-99	6 and 12 months	19% to 24%	41,019,690,000
Dec-01	6 and 12 months	14% to 24%	47,399,690,000
Dec-00	6 and 12 months	19% to 24%	71,209,690,000
Dec-02	6 and 12 months	14% to 25%	109,679,690,000
Dec-03	6 and 12 months	11% to 25%	61,521,590,000
Nov-04	6 and 12 months	11% to 17%	405,758,540,000

The sale of BOL-bills from December 1990 to November 2004 by the The Bank of the Lao PDR:

Year of issuing	Maturity	Interest rate per year	Total amount (kip)
Dec-90	3 months		-
Dec-91	6 months	24%	200,000,000
Dec-92	6 months	24%	800,000,000
Dec-93	6 months	24%	400,000,000
Dec-94	-	-	-
Dec-95	6 months	24%	12,980,000,000
Dec-96	6 months	24%	21,710,000,000
Dec-97	6 months	24%	29,310,000,000
Dec-98	6 months	30%	43,020,000,000
Dec-99	6 months	60%	141,610,000,000
Dec-00	3 months	42%	199,200,000,000
Dec-01	3 months	30%	199,920,000,000
Dec-02	3 months	18%	165,820,000,000
Dec-03	6 and 12 months	18%	45,520,000,000
Nov-04	6 and 12 months		

Costs and Benefits of Issuing Government Securities

The Costs:

Since the government securities were issued from 1990 to the end of 2004, the government has incurred a total cost equivalent to about US$120 million which can be broken down as follows:

- The T-bills interest cost is estimated at about US$47.0 million.
- The recapitalization of 7 state-owned commercial banks in 1994 is about US$15.0 million.
- The repayment of government debt in 2003 and 2004 to companies for infrastructure construction is about US$24.0 million.
- The BOL bills interest is estimated at about US$34 million.

The Benefits:

Although the benefits of using the government securities can not be measured financially, economically, the benefits for the economy cannot be counted. The salient contribution of the government securities is its achievement in bringing down the very high inflation rate in 1989, from almost 90 percent to a single digit number during the early 1990s, and from 167 percent in 1999 to a single digit number in 2001. The fluctuation of the kip was stopped and economic stability was regained. In addition to this, the government securities were also used to mobilize funds for budget deficit, to recapitalize the state-owned banks, and to repay the government debt to the local companies.

The Weaknesses of Past Utilization of Government Securities

Firstly, the issuing of government securities did not meet the urgent need of the economic situation. The main reasons behind this are that there was no proactive approach to prevent any crisis, there has not been a clear system of issuing these securities in place, and there is no clear division of responsibilities at the governmental level, namely the Prime Minister's Office, the MOF and the BOL. Besides these, the coordinating unit together with the detailed working procedures before and after launching the government securities were not created within the MOF or the BOL themselves.

Secondly, the revenue of the national budget has been short of the planned target every year. This creates problems for current expenditures and capital investment of the government. In addition, it causes the MOF together with the BOL to hesitate to launch government securities with attractive interest rates to protect against inflation and seasonal budget deficits.

Thirdly, the legal framework on the issuing of government securities has not been adopted or in place to determine the principles and responsibilities mainly between the MOF and the BOL in utilizing government securities with different maturities to finance government projects. This issue also affects the ability of the BOL to adjust the money liquidity in the market to control inflation to be at a level acceptable to the general public.

CHAPTER IV

How Can Government Securities be a Sustainable Tool for Raising Funds and be an Influential Monetary Instrument?

Definitions of Government securities

First of all we have to understand what government securities are.
In general, government securities can be classified into the three following categories:

1. **Treasury bills (T-bills):** T-bills are short-term government securities which may have a maturity of three months, six months, nine months or one year. There is minimum face value on these bills and it is larger than the minimum face value on the Treasury notes (T-notes) and Treasury bonds (T-bonds), e.g. 10,000,000 kip. There is no stated interest; rather bills are sold at discount. A ten million kip bill, a three month T-bill, may sell at 9.8 million kip. The discount is 200,000 kip. The buyer gains interest by purchasing the bill for 9.8 million kip and redeeming it for 10,000,000 kip on the maturity date.
2. **Treasury note:** T-notes have a stated coupon rate of interest and the interest is most often paid every six months. The minimum face value on the T-notes may be one-tenth of the T-bills, that is, 1,000,000 kip. They are issued for periods of one to ten years. Notes are usually sold at a discount, making the yield-to-maturity higher than the stated coupon rate of interest.
3. **Treasury bonds:** T-bonds usually have a maturity of five years or more. They also have a coupon rate of interest that is usually paid every six months. The minimum face value on the Treasury bonds can be as low as 500,000 kip.

What is the Primary Market for T-bills, T-notes or T-bonds?

A primary market is one in which the borrower sells debt directly to the lender; when the debt is sold, the borrower creates a new credit instrument, thus expanding the supply of credit.

When we talk about selling debt or borrowing money because of our credit, we should also talk about debt management. Who should manage the debt? How are we going to use the money? And how are we going to repay the creditors on time? These have to be managed very carefully. Thus, the government-debt refinancing requires cautious consideration. The principles which the MOF should take into account in the management of its debt are as follows:

(1) Cost minimization;
(2) Assuring economic stability;

(3) Creation of primary and secondary markets.

Cost minimization:

The need for the fund must be carefully worked out to know exactly how much and for how long the fund is needed. We can then design the type of debt we will sell. In the Lao PDR, there are times that the national budget cannot supply cash for the current expenditure due to seasonal difficulties. Therefore, short-term Treasury-bills can be issued to get the cash and many costs can be avoided.

Stabilization:

Whenever there is excess liquidity in the economy, the Lao PDR has found that the most effective and quickest way to absorb it is to issue Treasury bills with interest rates close to the market rate. Indirect monetary instruments must be strengthened in the Lao PDR, and the BOL should apply more market mechanisms in implementing the monetary policy. For example, the BOL can make use of the base money level to manage the money supply, and the BOL should be allowed to invest in government securities which it can use for repurchase agreement (repos) or outright sale in the open market to promote the secondary market.

Why Do We Have to Create a Reserve Money Program at the BOL?

The creation of a reserve money program has the objective of stabilizing the value of the kip or controlling the inflation rate to stay at a certain level. One variable which directly impacts the inflation rate is the money supply in the economy. In the money supply, the part of the Central Bank which has the database, and which can be controlled and monitored correctly and rapidly, is the reserve money.

Therefore, from gathering various data which constitutes the reserve money every day, every week and every month, we can know the liquidity of the money supply in the economy, and whether it is too much or too little. Furthermore, from the study of various variables which can impact liquidity in each period, we can create a reserve money program to withdraw the excess liquidity into the Central Bank or inject liquidity into the economy when necessary.

The procedure of estimating and monitoring the movement of each component of the reserve money and the intervention of the Central Bank in the money market or the open market operation is the basic monetary management of the Central Bank.

Effectiveness of the Reserve Money Program

The effectiveness of the reserve money program depends on the ability of an up-to-date statistical compilation of the reserve money each day, without waiting for the latest monetary survey, which can take weeks, in order to find out whether the liquidity situation is compatible with the inflation rate target or not. When we know the latest reserve money amount, the Central Bank can determine how much liquidity to inject into or withdraw from the market.

The use of a reserve money program will also expand the use of indirect monetary instruments such as the T-bills and BOL bills. At the same time, the use of direct monetary instruments will be reduced. This should be strengthened because direct monetary instruments tend to be unsustainable and can distort the money market.

Coordination between the BOL and MOF

In the process of making use of the reserve money program, the Central Bank must have sufficient T-bills or BOL bills to use in the money market or open market operation at any time. For example, if the Central Bank wants to reduce its reserve money, it will sell these bills to withdraw excess liquidity. In order to withdraw or inject the liquidity from or to the market effectively, the Central Bank must develop the open market operation. According to past experience, the MOF has had some concern over increasing budget expenditures because of the rising interest payment of the increasing bills. BOL also was concerned about the deterioration of the balance sheet and the possibility of a loss. Therefore, the MOF and the BOL will have to decide how the cost of issuing the bills will be borne in order to achieve the final goal: to reduce the inflation rate and create economic stability.

Creation of Primary and Secondary Markets

By rule of thumb, in order to create a sustainable primary market of government securities, then T-bills, T-notes and the Treasury bonds must be liquid enough in the economy. For example, their total outstanding amount should be at least 15 percent of the GDP, so that the people can exploit the opportunity of these instruments in the primary and secondary markets. The maturity of T-bills should be increased from their present six months, and should be sold at discount because all of them currently have a coupon rate interest.

What Can We Do About the Development of Primary and Secondary Markets Given the Current Environment in Lao PDR?

First of all, we have to understand what primary and secondary markets are. The primary market is the first issuance of any financial product in the market to mobilize capital of the government or the public limited companies. These financial products may be government securities or company shares, and their sale may be made through auction, brokers of the stock exchange, or through media advertisement, telephone, or e-mail. The secondary market is the buying and selling of products which have already been transacted in the primary market through similar channels or forms as the primary market. The more liquid the products, the more active the secondary market will be.

Division of labor between MOF and BOL on the development of primary and secondary markets should be clearly understood. The authorities need to create the proper environment for such development. Normally, the MOF should look after the development of stock and commodities markets, while the BOL should take care of money and the development of inter-bank markets. However, the two institutions should work closely together to develop the financial markets of the country.

Therefore, in order to develop the primary market of the government securities and the stock exchange successfully, the MOF must play its role. The prerequisite is for a legal framework to be in place. Next, a committee or a commission responsible for this matter must be created to manage and monitor the work process in accordance with the set laws and rules.

If we look at bond market development in ASEAN countries, we can see that it is in different stages. Based on the final report of Nomura Research Institute (NRI) on bond market development in five ASEAN countries, including Malaysia, Indonesia, Thailand, the Philippines and Vietnam, it was found that many countries have developed the primary markets of government securities. They are entering the stage of full development of their secondary markets although their transactions are still limited. Therefore, in order to promote active buying and selling of the government securities, the issuance of securities must be regular and of sufficient amount, and they must also be transparent for the schedule of issuing plan. They must develop a sound banking system in order to have an active money market, and must strengthen the role of market creators such as the Central Bank. They must also develop a hedging market, and broaden the investor base by offering different types of risk with different maturities. In addition, the basic infrastructure that needs to be established is:

1. The equitable accounting standard.
2. The credit rating agency of the domestic enterprises.
3. The system of distributing information on the market of the Government securities/company shares or equities.

Obstacles or constraints related to the development of the secondary market of the government securities or company bonds include: repos

- low level of liquidity, little or no market;
- no active market creation by the sellers;
- investors are discouraged to participate in the secondary market.

In order to overcome these constraints, NRI sees the necessity to implement many effective measures at the same time such as:

1. Increase the liquidity of the financial products by creating a suitable environment for a repos market.
2. Design the obligations and privileges of the primary dealers to balance the interests of the primary dealers and the government or Central Bank.
3. Readjust the size of the bills/bonds issued by repurchasing those matured securities and by issuing a new batch.

The primary market has been on and off in the Lao PDR. In the past, a strategy was not developed to improve this market since each T-bill or BOL bill issued was for an ad hoc purpose. Continuous care was not taken to promote these instruments to be sustainable debt instruments or as part of powerful monetary management. Therefore, a decision from the top economic management team in the government is needed to make this happen.

In order to increase the professional way of working and to enhance the discipline of the two major financial market regulators (the MOF and the BOL), certain structures for coordination between the two institutions need to be established. A strategy to overcome constraints to develop primary and secondary markets needs to be in place, as are the soft ware and hardware resources of various stakeholders.

Capital is the Key to Take Lao PDR to a Higher Stage of Development

The prospects for different kinds of investment in Lao PDR are many. Medium and large hydro-electric dams of no less than 23,000 mw of installed capacity can be built. At least 24 types of mineral resources ranging from gold, silver, copper, bauxite, to coal, iron ore, tin, and potassium can be exploited. In addition, a large area of available land can be used for industrial plantation, and beautiful views, and scenic spots all over the country, including waterfalls, archeological and historical ruins, beautiful temples and a unique Lao tradition and culture can attract tourists.

However, these rich natural resources, available land and beautiful scenery will be meaningless for the Lao people if they are not tapped for use. However, those who wish to exploit them will need large funds in order to buy the technology to develop them. But where can we get these funds? What are their costs? How are we going to repay them and for how long? What are the alternatives to finding the funds available? Have we seriously started to look for them? How will the benefits be shared among the State, the Lao people and the foreigners? There will be more questions to which we should find the appropriate answers in order to balance the national interest with the cost of giving up our natural resources which may one day be depleted.

Chapter V
Policy Recommendations

The development of any system or mechanism in any economy should start from what already exists. Anything which has had a good start will need to be strengthened and questions can be asked: Is there anything which has been in place but needs to be adjusted or amended? Is there anything which has does not exist but needs to be put in place in accordance with the reality of the country but consistent with international practice? As for Lao PDR, the commercial banks play a major role in the money market in the country and ought to be given a high priority to be strengthened. The development of a basic infrastructure to develop government securities and the bond market and stock exchange is also urgent work that needs to be done. Therefore, the development of the Lao financial market should pay attention to strengthening the commercial banks. At the same time, the laying out of a system and the legal framework to develop the securities market and the stock exchange should be created.

Listed below are a set of policy recommendations:

1. Financial Sector Strengthening

The Lao financial sector, despite improvement that has been made over the last 20 years, is still at an early stage of development in all fields when compared to neighboring countries such as Thailand and Vietnam. The sector has limited resources, particularly human capital, and therefore institutional and human resource strengthening should be one of the first priorities for developing the Central Bank. This strengthening includes:

(1) Setting up appropriate departments of the BOL to be really central.
(2) Clear job descriptions for each position, in each department, must be in place.
(3) Existing rules and regulations of the BOL must be verified, updated and enforced. The outdated ones must be abolished.
(4) Full autonomy of state-owned commercial banks must be restructured in order to compete with private banks internationally and locally. A feasibility study should be conducted for a possible joint-venture arrangement with an international commercial bank to modernize the Lao banking industry.
(5) Strategies for the financial sector must be laid out, such as a strategy to promote the use of the kip, to manage foreign exchange, to adopt high technology such as ITC, and to overcome the constraints in developing the primary and secondary markets.
(6) The existing banking college must be upgraded and modernized to produce new human capital for the banking and financial sector.

(7) Integration of the branches of the foreign banks with the local banks must be promoted in order to create effectiveness of the monetary policy of the Central Bank.

As a policy maker and a regulator, the Central Bank must make use of its institutional framework and find some policy to utilize its limited number of staff to their utmost capacity in the most efficient way as possible. The embryonic indirect monetary instruments must be strengthened in order to influence the money markets and instill confidence in the public that the government's policy toward the market oriented economy is consistent. Techniques for managing the money supply, the reserve money or the excess reserve of the commercial banks must be well understood by the concerned staff of the Central Bank, so that they will know when it is necessary to absorb or inject the liquidity.

2. Creating More Confidence in the Public in the Banking System and in Lao Currency

In order to encourage more of the public to use banks, banks have to take a more proactive approach by offering better services, and easier ways to get access to and find their business solutions.

In order to promote more use of the kip in economic transactions, the government must maintain economic stability for a long period, from 15 to 20 years for example. Then people will not distinguish between the value of the kip and the foreign currencies in terms of hedging or speculation. The dollarization will then be reduced and the use of the kip in economic transactions in the country will increase. The Central Bank should issue larger denomination notes and should issue some legality that makes the kip a convertible currency.

3. Institutional Arrangements of Foreign Exchange Rate

As for the exchange rate policy, the government, particularly the Central Bank, has viewed the stability of the national currency as a very crucial element in its stabilization policy. In the early 1990s, stability of the exchange rate could be maintained because the government could meet the market's seasonal need for more foreign exchange each year.

At present, there are six market participants in the foreign exchange market in Lao PDR, namely the BOL, the MOF, the commercial banks, the licensed exchange bureaux, the illegal dealers and the traders. Prior to September 13, 1995, exchange rates were classified into two groups, the official rate and the parallel market rate. The official rate was set by the Central Bank by closely following the trends in the parallel market. Currently, the Central Bank deals only with the Ministry of Finance and the commercial banks, while the latter deals with licensed exchange bureaux, traders and the general public. Prior to the managed floating exchange system, the commercial banks set their rates in line with the official rates, with a small surplus margin. But the exchange bureaux set their rates close to parallel market rates with the allowance of a commission spread of no more than 1.5 percent between buying and selling.

The government is looking for measures to eliminate the illegal dealers and traders in the foreign exchange markets. While this is being done, it is strongly suggested that indirect measures be taken in order to increase the confidence of the public that the government is being consistent with its policy towards creating a market oriented economy. At the same time, they should minimize the use of administrative measures as much as possible. The action taken by the government on the floating of the kip to be determined by the market mechanism should be a good starting point in eliminating illegal dealers and traders. This has to be supported by institutionally strengthening and enforcing the existing laws and regulations in order to treat all concerned people fairly. Recently, the BOL promulgated a regulation concerning the announcement of a reference rate or central rate by the Central Bank. This regulation allows the commercial banks to set their own rates within the range of minus and plus 0.25 percent for the US dollar and the difference between the buying and selling rates must be within 1.15 percent of the selling rate.

Institutional arrangement for better management of an exchange rate policy can be complemented as follows:

- The BOL must promote the creation of private exchange bureaux or exchange agents in hotels around the country in accordance with existing regulations.
- The BOL must impose appropriate limits of net open position of foreign exchange for the commercial banks, which means what is the maximum or minimum limits of foreign currencies each commercial bank must maintain at their banks each day. The amount above the maximum limit, the commercial banks shall sell to the Central Bank and the amount below the minimum limit, they shall apply to buy from the Central Bank.
- The BOL must facilitate and promote the inter-bank foreign exchange market among the commercial banks as well as the MOF, exchange bureaux and large importers and exporters.

4. Institutional Arrangements of the BOL, MOF and Committee for Planning and Investment (CPI)

Efficient coordination between the Central Bank, MOF, and CPI at all times is necessary in regards to the use of indirect financial instruments, such as the allocation of Treasury bills to the Central Bank for monetary management or debt management. It is also crucial in relation to foreign exchange management since a substantial amount of the revenue is in foreign currency including revenue from tax and disbursements from grants and loans In order to be well coordinated, joint committees concerning monetary management must be organized between the BOL, CPI and the MOF to avoid unnecessary delays before and after making important government decisions.

Permanent joint-committees should also be set up to overcome redundant delays in the determination of T-bill auction quantities, the monitoring of programs agreed with international institutions, and the coordination of debt management and monetary policy, particularly the interest rate policy for government borrowing. Such committees also need to oversee characteristics and operational aspects of government securities, and the allocation of responsibilities for the development and regulation of financial markets. The creation of committees will bring a certain degree of discipline and order to the coordination process between these organizations.

5. Strengthening of MOF

For better management of fiscal policy, tax collection units at the grassroots level must be well equipped and appropriately stationed and their staff must be well trained. Encouragement and incentives must also be given to staffs who have successfully carried out their duties. Decrees on the implementation of the laws on budget, tax, and customs should be reviewed carefully, immediately amended, and completely enforced. Ministerial regulations and notifications on tax, duties and fees, and on formulating the budget for each ministry and each province must be issued based on the existing legal framework under the responsibility of the MOF.

The existing tax structure should be further studied and modified to suit the growing private business activities which are the main targets for tax revenue now and in the future. In principle, taxes should be fair and easy to apply and should be broadly based rather than discretionary. The institutional set up must be strengthened and upgraded in these areas, and a research center for fiscal and monetary policies should also be established.

In addition, the MOF should coordinate with the BOL to set measures for each period to achieve the goals of the strategy to integrate all ASEAN member countries in the financial sector by the year 2020, namely: (1) capital market development; (2) the liberalization of financial services; (3) the liberalization of capital accounts; and (4) the currency and exchange rate cooperation.

6. Legal Framework to Develop the Primary and Secondary Markets

There is some legal framework for the primary and secondary markets in the Lao PDR, but they are combinations of different laws and decrees, such as the law on the creation of the BOL, the decree law on commercial banks, the decree law on the management of foreign exchange and precious metals, the decree on the bill of exchange and promissory note and the decree on cheques. This legal framework is neither salient nor remarkable. Therefore, in order to have firm legal ground on which to develop the primary and secondary markets, it is recommended that a new set of laws and regulations be drafted and finally adopted by the National Assembly and the government, taking into account what already exists.

In addition, there should be a legal framework that divides the responsibility on issuing, managing and repaying government securities between the MOF and the BOL. This legal framework should determine the principles of how the interest rates should be set; how the maturities of the securities should be determined; how their liquidity could be increased, and how to make them negotiable instruments; and how the long-term government securities should be developed. (A draft decree or decree law is proposed below). The MOF should also make regular use of government securities as an important debt instrument in order to develop the stock exchange which has higher risk, including the company's bonds and company's equities. The government should promote the state-owned enterprises dealing with utilities such as the Electricite Du Laos (EDL) and the Water Company (Nam Papa Lao) to issue their shares or debt instruments to mobilize part of its financing.

Appendix

"Draft"

Decree Law/Decree on
The issuance of short term and long term government securities for sale

Based on

The President of the Lao PDR/The Prime Minister of the Lao PDR issues this Decree Law/ Decree as follows:

Article 1: Definitions of the words used here.

T-bill/bond: means the financial instruments which the government issues for sale or to capitalize for its assets. The government will redeem these bills/bonds and pay interests when they reach maturity. These instruments may be short or long term, and will be called bonds hereafter.

Financial institution: means the commercial banks licensed to operate in the money market in the Lao PDR, the specialized banks, the development fund, the credit cooperatives, the insurance companies, the exchange bureaux, the pawnshops, the depositors protection fund which lawfully operate in the Lao PDR.

BOL: is the acronym for the Bank of the Lao PDR.

MOF: is the acronym for the Ministry of Finance.

CPI: is the acronym for the Committee for Planning and Investment.

Company: means a legal entity incorporated in the Lao PDR and which has a turnover of 500 million upwards.

People: means a person who has a Lao nationality, no nationality or foreign nationality but who has been a Lao resident for more than one year.

Article 2: Objectives of the bonds

The MOF will issue the bonds with the two main objectives.
(1) To mobilize capital within the country to ensure the implementation of the budget according to the plan adopted by the National Assembly with the essence of trying to achieve more than the planned targets and to manage the expenditure efficiently. (2) To turn these instruments into monetary instruments for macroeconomic adjustment and to develop the primary and secondary markets in the Lao PDR.

Article 3: Principles of setting interest rates of the bonds

The interest rates of the bonds shall be determined based on the following two principles:
The first principle: The MOF in coordinating with the BOL shall determine the interest rate of each type of bond. Such interest rate shall be positive compared with the inflation rate in each period, aimed to attract the potential buyers.
The second principle: The interest rate of each type of bonds shall be determined from the outcome of the bond auctioning in each period.

The MOF and the BOL shall use these two principles flexibly and creatively.

Article 4: Types of bonds

The types of bonds may be divided in three categories as follows:

(1) Short term bonds with maturity of up to one year.
(2) Medium term bonds with maturity from 2 to 4 years.
(3) Long term bonds from 5 to 10 years.

Each type of bond may have many maturities.

Article 5: Liquidity of the bonds

All types of bonds and all maturities shall be considered as money. They shall be negotiable and can be used as collateral to borrow unconditionally from banks.

Article 6: Channels to mobilize capital with the sale of bonds

Capital mobilization through the sale of bonds may be implemented in the following three channels:

(1) The MOF mobilizes the capital directly from the people through the National Treasury which will organize the sale of bonds themselves.

(2) The MOF mobilizes the capital directly from the people through the commercial banks with their agents selling bonds for them. The MOF shall pay fees to their agents.

(3) The MOF mobilizes the capital from the financial institutions and from the companies through the BOL. The BOL will be their agent and will organize the bonds auction. The MOF shall pay fees to the BOL. In the case the BOL holds the bonds auction for macroeconomic adjustment of money supply, the payment of interest and the repayment of the principal shall be assumed by the BOL.

Article 7: Assignment of rights to agents of the MOF and the allocation of bonds to their agents

The MOF shall issue a letter to assign rights to a legal entity to be their agent in mobilizing capital from various sources in order to finance their annual budget. In such a letter, there shall be a stipulation of obligations and interests of each side. In the allocation of the bonds to their agents, rights and obligations of each side shall also be stipulated.

Article 8: Redeeming the bonds

All types of bonds shall be redeemed and all interests shall be paid by the MOF when they reach maturity. Roll-over of the bonds is prohibited.

Article 9: Coordination between the MOF, the BOL and CPI

The MOF, the BOL and the CPI shall organize a technical unit at the departmental directors' level to undertake the following duties:

(1) Study the relationship between debt management of the government and the monetary policy.

(2) Study the amount of bonds to be issued each time.

(3) Make proposals of the interest rate policy for the debt of the government, determine different characteristics of the bonds such as the different maturities, the negotiability of the instruments, the potential for discount of the instruments, the frequency of the bonds auction, the channels to sell directly to the people and so on.

(4) Study the policy to develop and responsibility to supervise the financial market in the Lao PDR.

Article 10: Final provisions

The MOF, the BOL and the CPI shall implement this Decree Law/ Decree seriously.

This Decree Law/ Decree is effective from the date of signature.

Vientiane, dated …

The President/The Prime Minister of the Lao PDR

Notes:

1. Workshop on Bond Market Development, 25 and 26 May 2004, Bali Indonesia, organized by the ASEAN Secretariat.
2. Annual Reports of the Bank of the Lao PDR from 1992 to 2002.
3. Answers to the IMF questionnaires compiled by the Economic Research Department, BOL for February 1993, September 1993, April 1994, September 1994, May-June 1995 and January 1996.
4. Financial Magazine of the MOF: Issue No. 1 of the first year for the month of December 1995.
5. Lao legal framework during the 1980s and 1990s concerning the monetary and fiscal policies.
    - Decree No. 9 on state tax policy of March 1988.
    - Decree No 11 on banking reform of March 1988.
    - Decree No 47 on state tax policy of June 1989.
    - Decree No 99 on land of December 1990.
    - Customs Law of July 1994.
    - Business Law of July 1994.
    - Tax Law of October 1995.
    - Laws on Foreign Direct Investment of 1988, 1994 and 2004.
6. Murano T. and Tacheuchi I. editors of Indochina Economic Reconstruction and International Cooperations, printed in 1992.

4. Financial System Development and a Study on DFIs in Lao PDR

Masahisa KOYAMA

The following report is aiming at responding to a Lao Financial Working Group proposal for establishment of development financial institutions (DFIs). A Japanese mission team headed by Professor Masaaki Komatsu conducted on-site interviews twice in 2004. This report covers new findings based upon those interview outcomes and the latest financial statistics and data related to Lao's financial system development, and updates a former interim report. The first part of the report reviews the financial system development and current conditions in Lao People's Democratic Republic (PDR) and then discusses the proposal for establishment of DFIs. The contents of the report are as follows.

Contents

1. Financial system development in Lao PDR
1-1. Financial system development in transitional economies in East Asia
1-2. Review of financial system development in Lao PDR
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2. Problems in the banking system in Lao PDR
2-1. Low financial depth
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2-3. Unsound balance sheets and loss making operations in SOCBs
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3. Observation of the formal financing activities in rural cities
3-1. Recent banking operations at SOCBs' local branches
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4. Evaluation of the banking sector reform and a proposal for establishment of DFIs
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4-3. Sequence of the establishment of DFIs

1. Financial system development in Lao PDR

1-1. Financial system development in transitional economies in East Asia

The financial system development patterns in such transitional economies as Viet Nam, Cambodia and Lao PDR have some common features. (The chart below shows a typical trend for financial system development towards a liberalized and market-based financial system from formerly government directed mono banking system.) Those countries successfully established so-called two tier banking systems (separation of central banking functions from commercial banking functions) from former mono banking systems in the early 1990s. However, their banking sectors are still facing the following difficulties:

- off balancing non-performing loans (NPLs) and lack of capital increase in their financial bases (preventing establishment of reliable commercial banking systems),
- existence of directed finance by government intervention
- lack of management capability and weak governance in improving banking services profitability in the economy, and
- weak implementation of monitoring and supervision activities by the central bank (preventing reliable banking systems).

Since further economic development can not be achieved in transitional economies without efficient and productive financial intermediary functions, each country should speed up its bank restructuring in a precise manner.

Chart 1. Financial system development in transitional economies

Mono banking →	Two-tier banking →	Liberalization
State treasury (MOF)	State treasury (MOF)	State treasury (public finance)
- State bank functions	① Central bank function →	Independence from Treasury (State budget)
● Treasury A/C	● Treasury A/C	
● Central bank	● Money supply control	
● Commercial banks	● Interest rate control	
- Foreign exchange	● Bank supervision	
- Development finance	● Inter-bank settlement	
→Loans for SOEs	② Commercial banks →Further liberalization (competition)	
	- State-owned CBs → NPL restructuring → Privatization (listing)	
	- Private CBs →Business expansion expected	
	- Foreign bank branches →Market expansion (alliance) expected	
	③ Separation of policy-based banks as DFIs from SOCBs	
	④ Informal banking system →Institutionalization	
	⑤ Money market development	
	⑥ Capital market development (Treasury Bonds, Securities)	
		Issuing market →Secondary market

No clear definition on state budget and finance → Separate financial system from fiscal system

In Viet Nam, financial system development has progressed recently in line with the stabilization of the macro economic condition. Interest rates were fully liberalized in the market, and the securities market has already started operations with an adequate legal and regulatory framework. Some of the state-owned commercial banks are still in the process of restructuring for NPLs liquidation and preparing for future listing on the stock market in Ho Chi Minh City (HCMC). Separation of the policy-based finance function from state-owned commercial banks has been accomplished, and two policy-based financial institutions have been created—namely, the Development Assistance Fund (DAF), which covers infrastructure development and strategically important industrial development projects in the country and also has an on-lending function from donor institutions like the World Bank or the Japan Bank for International Cooperation, and Viet Nam Bank for Social Policy (VBSP), which aims at promoting rural micro credit and small and medium enterprises (SME) financing for poverty eradication. Those policy-based financial institutions are operated under strong governmental direction. We have to carefully watch the soundness of their lending operations, because their autonomy in governance seems limited as yet.

Looking at Cambodia, financial reform has progressed in line with the ten-year blueprint from 2001 to 2010 instructed by an Asia Development Bank expert in consultation with the National Bank of Cambodia. *New Law on Banking and Financial Institutions* was adopted in 1999, stipulating relicencing for existing viable commercial banks with adequate capital and asset quality. As the result of this restructuring program, 15 non-viable banks were closed and liquidated. Currently Cambodia's banking system comprises the National Bank of Cambodia (NBC) as the central bank, with 20 provincial branches, 13 commercial banks (1 state-owned, 3 foreign bank branches, and 9 locally incorporated banks), 4 specialized banks (1 state-owned, and 3 privately owned banks), and 1 representative office of a foreign bank. Specialized banks have mainly rural and micro credit functions under the NBC's supervision. Since those relicenced banks are guaranteed their viability by the NBC, deposit collection has been smoothly expanding lately. Bank supervision by the NBC seems to have been strengthened by the introduction of modern inspection and auditing methods. The problem is real enforcement of strict regulations and rules. Exploring for domestic loan opportunities seems another difficulty for Cambodian commercial banks. The loans to deposits ratio is now below 50 percent, indicating a lack of loan demand in the real business field and high macro economic risks.

As for the banking system in Lao PDR, the dominating state-owned banks are still struggling to solve heavy accumulations of NPLs caused by the steep depreciation of the local currency (kip) in US dollar denominated loans after the 1997 Asian financial crisis and the directed finance succeeded from old regime. These accumulations are the result of loans to loss making state-owned enterprises (SOEs) and provincial government's directed loans to local contractors. In order for state-owned commercial banks (SOCBs) to solve their NPL problems and achieve the necessary capital adequacy, a huge amount of budget is needed. However, another difficulty is the shortage of national budget. Recently SOCBs' loan assets have been flush with loss provisions, which has caused deterioration of equity in the balance sheet. Without restructuring of SOCBs, further financial system development can not be achieved. Recent condition of NPLs and capital ratio is as followed.

Table 1. Trends of Non Performing Loans (NPLs) Ratio (%, 10 billions of kip)

	1995	1997	2000	2001	2003
NPLs ratio (%)	35	60	70	56	64
Provision for NPLs (10 billion kip)	44	52.7	55.5	25	387
Capital injection by the Government	*26	-	-	-	-
Capital ratio (%)	12.2	13.6	13.7	13.1	3.7

Source: Furukawa(2004), data from BOL, ADB, and IMF

Note: *26: 1993-1994

1-2. Review of financial system development in Lao PDR

According to the research paper "Banking and Financial Sector of Lao PDR" published July 15, 2002, the history of Lao's financial sector development is divided into three periods since the New Economic Mechanism (NEM) was initiated in 1988, summarized as follows.

(1) First period (1988-1991): Transition from mono-banking toward two-tier banking system

The mono-banking system instituted in the State Bank of Lao (SBL) since 1975, was replace by a two-tier banking system (March 1988). The commercial banking functions of SBL were separated from its central banking functions. In 1990, the Bank of Lao PDR (BOL) was established as the central bank by the Central Bank Law (Law No.4). At this time seven SOCBs, including Bank pour le Commerce Exterieur du Lao (BCEL), Lao Mai Bank, and Lane Xang Bank, started commercial banking operations under the BOL's management control and each was assigned a geographical area of coverage. Also, Lao's first joint venture bank (30% BOL equity and 70% Thai investors' equity) was established, named the Joint Development Bank.

(2) Second period (1992-1995): Private bank expansion and foreign bank participation

Prime Minister Decree No. 3 of 1992, stipulating the establishment, management and operation of commercial banks, was promulgated and triggered the expansion of private-owned banks, especially encouraging foreign bank participation in Lao's domestic financial market. Six branches of Thai banks (Siam Commercial Bank, Thai Military Bank, and Thai Farmers Bank, and others) and one branch of a Malaysian bank (Public Bank) were established. In 1993, the Agriculture Promotion Bank (APB, state-owned) was established by Prime Minister Decree to promote the rural agriculture sector development. In this period, improvement in legal and prudential framework could be seen; however, due to the weak enforcement of the regulations, NPLs for SOCBs accounted for over 35 percent of the total loan amount in 1994. In order to achieve the capital adequacy requirement, the government implemented a first round of recapitalization for the SOCBs.

(3) Third period (1996-): Improvement in prudential regulation for commercial banks

In 1996, six prudential regulations for commercial banks and APB were issued by the BOL and a new regulation on asset classification and loss provisions was promulgated. In 1997, *Decree Law on Management of Commercial Banks and Other Financial Institutions* replaced the former Decree No. 3 of 1992, identifying boards of directors as the policy making bodies of the SOCBs, and vesting in the Ministry of Finance (MOF) the power to appoint the chairman and other board members. Despite improved bank regulations, SOCBs have continued poor performance due to weak implementation and enforcement. At the end of 2004, the banking system in Lao PDR comprised

- three state-owned banks,
- three joint-venture banks,
- six branches of foreign banks, and
- one representative office (Standard Chartered Bank).

Details are shown in table 2. The number of the formal banks decreased by one due to the retreat of one from the Lao market, and state-owned bank branch numbers have dropped by thirteen since the end of 2001 due to the restructuring of the banking system. Thirteen banks, including the dominating state-owned banks (fifty-two branches), are now operated under the BOL's supervision. The LDB and APB have wide branch networks which cover most of the provincial capitals. Foreign banks are still not allowed to establish branch offices anywhere other than Vientiane. The formal banking system and service network in Lao PDR seem still limited in terms of banking accessibility in the country and quality of services (e.g., inter-bank money transfer and settlement, and teller services at branch counters).

Table 2. Formal banks and market share in Lao PDR

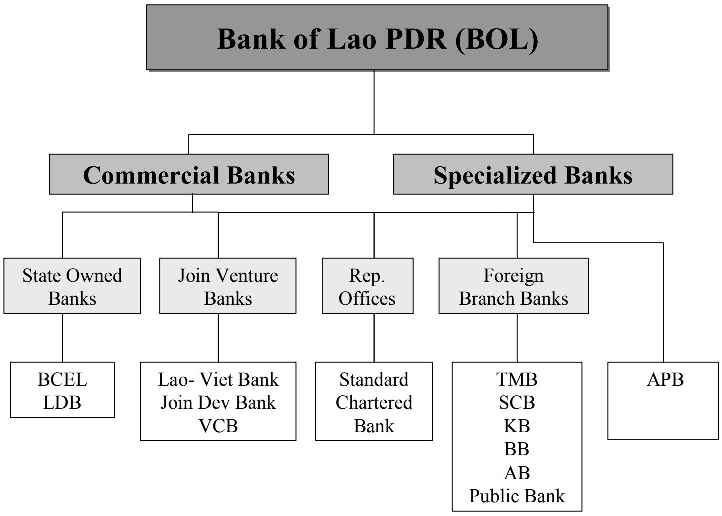
Type	Establishment	Branches (2001→2004.11)	Deposits (end of 2003)		Credit (end of 2004.07)	
State-owned banks (3)			**3,422**	**74.7%**	**1,191**	**63.1%**
1. BCEL	1989.11	4 → 7	2,028	44.2		
2. LDB (Former Lane Xane, Lao May Bank)	2003.01	21 →18	1,182	25.8		
3. APB	1993.08	30 →17	212	4.6		
Foreign bank branch (7→6)			**485**	**10.6%**	**377**	**20.0%**
4. Bangkok Bank	1994.10	1 → 1	90	2.0		
5. Siam Commercial Bank	1992.12	1 → 1	88	1.9		
6. Krunghtai Bank	1994.11	1 → 1	47	1.0		
7. Ayoudya Bank	1994.11	1 → 1	39	0.9		
8. Thai Military Bank	1992.02	1 → 1	66	1.4		
9. Thai Farmers Bank (closed in 2002)	1993.05	1 → 0	-	-		
10.Public Bank (Malaysia)	1995.11	1 → 1	107	2.3		
Joint-venture banks (3)			**677**	**14.8%**	**319**	**16.9%**
11. Vientiane Commercial Bank (Lao private 25%, foreign 75%)	1993.02	1 → 1	131	2.9		
12. Joint Development Bank (BOL 30%, Thais 70%)	1989.10	1 → 1	193	4.2		
13. Lao-Viet Bank (BCEL 50%, BIDV 50%)	1999.07	2 → 2	353	7.7		
Representative offices (1)						
Standard Chartered Bank	1996.02	(1) →(1)				
Total 13 Banks		**65 →52**	**4,584**	**100.0**	**1,887**	**100.0**

Sources: Furukawa (2003), *Development and International Cooperation in Lao PDR*; NERI; NGPES, *The National Growth and Poverty Eradication Strategy* (2004).

1-3. Structure of the formal banking system in Lao PDR

The latest structure of the formal banking system under BOL supervision is as shown in the chart below. Besides this, informal money lender and micro credit financial services with support from non-governmental organization groups are operated and cover the rural financing at a marginal level. Those informal financial services have a reputation of charging high interest rates to borrowers. According to the SMEs promotion team's survey in this joint study, some small retail shops in the local market use short-term credit for working capital financing, and this is regularly provided by dealers or wholesalers through good connections. Paying in cash is a common type of trade in Lao PDR, which indicates limited credit expansion and financial access for business activities.

Chart 2. Banking system structure in Lao PDR



Source: NERI, internal paper.

1-4. Recent measures taken for financial sector reform and its impact

In order to recover the creditworthiness of the commercial banks in Lao PDR and strengthen their capabilities as financial intermediaries, the Government of Lao (GOL) has introduced a series of measures since 2001. Some of the important measures for the financial sector reform are listed below (source: WB Vientiane Office, *Economic Monitor* [May 2004].

- stipulating commercial banks to make general provision from 0.5% to 1.0% of performing loans (Notice No. 95/BFSD Mar. 19, 2001);
- reiterating that commercial banks set ceilings for lending (at 60% of collateral value and at 10% of the bank's capital to a single borrower), suspend accrued interest income on loans which become overdue for longer than 90 days, and prohibit new lending to defaulted borrowers (Notice No. 209/BFSD Jun. 15, 2001);
- reiterating general reserve requirement and compliance with Regulation No. 98/BOL on loan classification (Instruction No. 176/BOL Jun. 30, 2001);
- prohibiting SOCBs from providing policy-based lending (other than for infrastructure projects, promotion of exports and import substitutes, and rice plantations) and requiring them to focus on loan recovery;
- restricting SOCBs from increasing their risk portfolios if their flow NPL ratios exceed 15% and lowering their branches' approval limits (aimed at stopping further deterioration of SOCBs' loan assets) (Instruction 01/BOL Mar. 14, 2002);
- ensuring SOCBs to have full autonomy in operating their banks on a commercial bases (Notice No. 566/MOF Mar.31st 2002);
- establishing the Rural and Micro Finance Committee (RMFC) under the BOL to assess the rural and microfinance industry, formulate policy statements, and develop action plans for the implementation

of reform programs (Feb. 15, 2002);

- establishing the External NPL Collection Committee (ECC) under the BOL, with the mandate to support debt restructuring on a voluntary basis by SOCBs and debtors (signed MOUs for each SOCB Mar. 31, 2001);
- merging two SOCBs, Lao Mai Bank and Lane Xane Bank, into the Lao Development Bank (LDB) (end of 2002);
- signing the Governance Agreement between the BOL, the MOF, and each SOCB (its board of directors and management) to restructure and strengthen that SOCB's management capability (Mar. 20, 2003);
- recruiting international bank advisors (by the BOL) to strengthen the soundness of SOCB management (working since Apr. 2003);
- amending former BOL regulation on loan classification, foreign currency exposure, and lending limits (being drafted);
- instructing BCEL and LDB to limit their net new lending since their NPLs exceed 15% (to force SOCBs to comply with prudential regulation and avoid further deterioration in their loan portfolios (2003);
- endorsing in principal, via the Prime Minister's Office, the rural and micro finance policy and action plan in Dec. 2003 (Notice No. 1760/PMO Dec. 17, 2003);
- Issuing MOF "triangle" bonds to SOCBs, which are designed to solve specific NPLs caused by government arrears. In July 2003, 120 billion kip was issued with a one-year tenure and 11% semi-annual coupon. A second lot of 120 billion kip was issued in Sep. 2003 with a two-year tenure and 11% semi-annual coupon.

The above listed series of measures since 2001 has strongly impacted commercial banks' risk management systems and loan portfolios, reducing further deterioration of loan assets. We could observe some of the impact of those measures and that is depicted below in table 3, which shows the recent trends of all commercial banks' deposits and credit in comparison with those of two SOCBs, BCEL and LDB. Total deposits have steadily increased in line with the stabilization of the Asian financial crisis in the middle of 1997, and the latest deposits to GDP ratio is around 17 to 18%. The domestic credit to GDP ratio has declined to 9 to 10% due to SOCBs' cautious lending behavior (under strict monitoring by international consultants and the BOL) and being NPLs written off in line with the restructuring process. Listed below are several characteristics in the structure of deposits and credit in Lao's commercial banks.

- The share of foreign currency deposits to all deposits outstanding is a dominating 70%.
- However, Kip-denominated deposits have gradually increased in line with the recent stabilized macro economic condition.
- Bank credit is mostly mobilized to the private sector (around 70%) and exposure to SOEs has decreased to around 20% lately.

- The share of foreign currency loans to total loan outstanding is about half, less than that of deposits, showing both the lack of loan opportunities in Lao and the strict risk management for foreign currency loans in the commercial banks.
- SOCBs still dominate Lao's formal banking system, with a 72% share of deposits and a 56% share of credits. However, other commercial banks have increased their market shares during the restructuring of SOCBs, causing a more competitive market condition in growing private sector businesses.

Table 3 Integrated balance sheet of all commercial banks in Lao PDR (2000-2004)

(billions of kip equivalent, end of period)

	2000		2001		2002		2003		2004.09	
Deposits	2,182	15.9	2,598	16.5	3,301	17.9	3,822	16.9	4,462	N.A
Kip deposits	469		569		810		1,198		1,428	.
FC deposits	1,723		1,713		2,019		2,634		3,034	
Domestic credit	1,297	9.5	1,893	12.1	1,928	10.4	2,021	8.9	2,151	N.A
To SOEs	260		533		566		451		425	.
To private	1,109		1,382		1,329		1,327		1,527	
FC credit	810		974		961		974		1,190	
SOCBs' shares of totals										
Deposits	1,712	78.5	2,009	77.3	2,480	75.0	2,822	73.8	3,217	72.0
Kip deposits	372		432		605		903		1,046	
FC deposits	1,340		1,578		1,875		1,919		2,171	
Domestic credit	815	62.8	1,281	67.6	1,222	63.3	1,152	57.0	1,213	56.4
To SOEs	217		419		449		331		280	
To private concerns	665		885		776		620		796	
FC credit	660		1,019		1,028		817		899	
Nominal GDP	13,672	100	15,705	100	18,390	100	22,536	100	N.A.	

Source: IMF (2004), Selected Issues and Statistical Appendix (Jan. 2005).

Note: Percentage in SOCBs data is relative to commercial bank totals

2. Problems in the banking system in Lao PDR

2-1. Low financial depth

Financial system modernization and liberalization has slowly progressed in transitional economies in East Asian countries such as Viet Nam, Cambodia, and Lao PDR. Those countries are still in the process of transition toward market-based economies. Their banking sectors are commonly facing difficulties in expanding banking business. A lack of domestic savings under the old planned-economy regimes, combined with unattractive interest rates (negative real interest rates for depositors and high interest rates for borrowers due to the vulnerable macro economy), inconvenient other banking services for depositors and borrowers, and a lack of trust in the banking system are factors which constrain further development of banking business. The table below indicates comparative trends of financial depth in transitional economies in South-East Asia. We can see recent improvement of financial depth in Viet Nam. It seems to be linked with the stabilization of the macro economy. Lao PDR and Cambodia seems struggling to improve the domestic financial depth due to the lack of capacity both lenders and borrowers. However, the domestic savings are gradually increasing due to the constant economic growth and the stabilized macro economic conditions.

Table 4. Financial depth

A. Domestic deposits (% of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Lao PDR	11.4	10.6	11.7	16.6	18.9	14.2	15.9	15.6	17.9	16.9
Cambodia	4.0	4.9	6.9	7.2	6.3	7.6	10.3	12.1	14.4	15.3
Viet Nam	N.A.	11.1	12.4	14.5	16.7	26.0	32.8	38.1	39.3	N.A.

Source: IMF International Financial Statistics (2003), ADB Key Indicators (2004)

B. Domestic credits (% of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Lao PDR	9.7	9.8	9.7	14.0	13.4	9.2	10.0	12.0	10.3	8.9
Cambodia	3.5	3.7	5.0	6.6	5.8	6.1	7.0	7.1	7.5	9.1
Viet Nam	N.A.	7.9	8.8	9.9	9.7	28.2	35.3	39.0	43.3	N.A..

Source: IMF International Financial Statistics (2003), ADB Key Indicators (2004)

C. Money and quasi money (M2) (% of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Lao PDR	14.9	13.6	14.1	18.5	20.4	15.0	16.5	16.4	19.3	18.2
Cambodia	6.6	8.0	10.3	10.9	10.8	11.5	14.2	16.5	19.6	21.1
Viet Nam	N.A.	19.8	20.9	22.6	24.2	36.4	44.6	51.8	53.3	N.A.

Source: IMF International Financial Statistics (2004), ADB Key Indicators (2004)

2-2. Low fund mobilization (weak financial intermediary function)

As shown above, the deposits to GDP ratio in Lao PDR is still low due to some historical reasons such as a failing experience of credit cooperatives, poverty, and unattractiveness of the banking services. The ratios are also indication of limited banking access in rural and remote areas. *The Banking and Financial Sector of Lao PDR* (2002) mentions several characteristics of the deposit structure in the Lao banking sector, and some of them are shown in table 5. Notable is the fact that SOCBs' market share and foreign currency deposits share have declined to 70 percent and less than 70 percent respectively lately when we compare the fact with latest balance sheets in table 3.

Table 5. Structure of Lao banking deposits (Dec. 31, 1999)

Type of Bank	Share	Currency	Share	Type of Depositor	Share	Area	Share
SOCBs	80%	Kip	15%	Individual	48%	Urban	90%+
Other Banks	20	Foreign	85	Firms	52%	Rural	10%

Source: *The banking and financial sector of Lao PDR* (2002).

The most basic function for the commercial banks is to mobilize individual deposits to productive projects or viable enterprises efficiently. This is a sound financial intermediary function needed for maintaining viability of the bank. Efficient and productive fund mobilization of the whole banking system will contribute to sustainable economic growth. To achieve this, a good risk management system, professional skilled workers, and a strict central bank monitoring system in line with adequate prudential norms will be needed. Looking below at the aggregated balance sheet of three state-owned commercial banks, we see a miserable static condition: the NPL ratio is over 50 percent; therefore, the losses account exceeds the total of capital and reserves, which causes negative equity. The loans to deposits ratio was 38 percent at the end of 2003, indicating low fund mobilization. And the high portion of foreign bank deposits shows a high degree of external capital flight (30-40% of foreign currency deposits), particularly through the Nostro account. There is also a lack of domestic foreign currency loan demand. With negative equity and bad quality assets, bank reliability is difficult to achieve, so they are forced to hold large sums of cash for liquidity and rely on tacit government guarantees on deposits. The deposits at BOL to deposits ratio shows a high degree, 23%.

2-3. Unsound balance sheets and loss making operations in SOCBs

(1) Unsound balance sheets in SOCBs

Table 6. Aggregated B/Ss of SOCBs at the end of 2003 (billions of kip)

Assets	Jan.2003	Dec. 2003	Liabilities	Jan. 2003	Dec. 2003
Reserves	566.1	755.9	Current deposits	289.8	410.0
- Cash	39.2	60.2	- Private sector	77.5	100.6
- Deposits at BOL	526.7	695.6	- SOEs	189.0	280.4
Foreign assets	884.7	878.7	Term deposits	143.9	449.4
- Nostro A/C	708.1	568.0	- Private sector	143.2	448.3
Claims on gov.	40.6	296.0	Saving deposits	115.3	236.4
- Securities	40.6	296.0	- Private sector	111.5	230.6
Claims on SOEs	442.5	338.7	Foreign currency deposits.	1,698.1	1,934.4
- Foreign currency	442.3	331.3	Restricted deposits	18.0	19.9
Claims on private	815.3	825.8	Foreign liabilities	508.2	309.9
- Foreign currency	527.5	493.7	Gov. deposits	30.5	80.7
Inter-bank transaction	64.1	137.7	Credits from money Authorities	222.9	165.6
Other assets	308.9	229.8	Other liabilities	146.2	168.1
			Total liabilities	3,172.9	3,774.4
			Equity total	-50.4	-311.6
			- Capital	26.8	34.6
			- Reserves	32.9	33.5
			- Provisional losses	-116.0	-390.2
Total	3,122.4	3,462.7	Total	3,122.4	3,462.7

Source: Compiled B/Ss from the BOL.

Table 6-2. Aggregated B/Ss of SOCBs at the end of 2002

Assets	Million kip	%	Liabilities	Million kip	%
Cash	331,950	9.1	Deposits	3,488,043	95.8
Inter-bank deposits	1,085,801	29.8	Borrowings	178,544	4.9
- Foreign bank deposits	891,908	24.5	-from BOL	132,368	3.6
BOL deposits	549,550	15.1	Other liabilities	132,513	3.6
Securities investment	108,661	2.9	Liabilities total	3,799,100	104.4
Loans	1,486,043	40.8	Capital	4,800	0.1
-NPLs	791,620	21.8	Accumulated reserves	44,444	1.2
-Written off (provision)	-237,956	-6.5	Losses	-210,852	-5.7
Other credits	755	0.0	Others	205	0.0
Fixed assets	73,840	2.0			
Other assets	239,053	6.6	**Equity total**	-161,402	-4.4
Total	**3,637,698**	**100**	**Total**	**3,637,698**	**100**

Source: Compiled from all SOCBs' B/Ss.

The Lao PDR definition for NPLs: 90 days overdue.

Some Ratios for your reference:

- Loans/Deposits: 42.8%.
- Foreign bank deposits/ Deposits: 25.5% (domestic savings → foreign assets).
- NPLs: 53.2% (NPLs do not produce interest return for banks).
- Equity: Negative (credit unworthy).
- However, the liquidity seems large: cash +bank deposits + BOL deposits/deposit =56%.

One SOCB's directors' as to the causes of its NPLs are as follows.

- BCEL case: 50% caused by loans to loss-making SOEs, 20% caused by local government imposition for construction projects, 30% caused by loans to private enterprises. Local government guaranteed loans for private road contractors have defaulted, reportedly due to shortage of budget. Those NPLs were gradually replaced by government bonds with a 11% coupon rate. Clearly the heavy burden of NPLs in commercial banks constraint efficient and constructive fund mobilization in the real economy.

(2) Weak profit and loss structure in SOCBs

Table 7. Aggregated profit and loss structure of SOCBs in 2004

(millions of kip)

Revenue Items		Expenditure Items	
1. Revenue from banking business	194,838	1. Expenditure on banking business	177,267
- Interest and revenue	100,325	- Interest and expenditure	128,119
- Leasing	138	- Leasing	73
- Fees	32,686	- Fees	4,737
- Revenue from financing activities	44,553	- Expenditure on financing activities	37,347
- Other revenue	17,135	- Other expenditure	6,991
2. Current revenue	346,567	2. Current expenditure	605,953
- Non banking revenue	345,856	- General expenditure on business	47,610
- Others	711	- Depreciation on fixed assets	13,255
		- Non-banking business	34,418
		- Loss from NPLs	508,993
		- Others	1,677
Total Revenue	541,404	Total Expenditure	783,221
		Profit and Loss	- 241,816

Source: compiled from each bank's financial statement

Regarding the aggregated profit and loss statement (P/L), SOCBs produced losses in 2003 due to the large volume of NPL provision. The problem, seen in the P/L, is the net loss in interest revenue and expenditure category, which is the foundation of commercial banking business. Net banking business profit was positive but interest profit was negative, indicating a very thin interest margin. Several reasons are identified below:

- Low loan to deposit ratio (inefficient fund mobilization)
- Accumulation of overdue and NPLs,
- Thin spreads (do not cover total funding costs)

Such structural problems that are seen in both BCEL and LDB have to be solved in order for these SOCBs to compete with private commercial banks. Improvement of profitability in banking business seems crucial in order to speed up the off-balancing of NPLs.

2-4. Issues on the interest rate structure

(1) Unattractive interest rate and banking services

According to the BOL, interest rate setting is currently fully liberalized and market-based interest rates have been introduced. However, SOCBs' interest rates are said to be determined at monthly member meetings. The tables below show the interest rate structure. We can observe some differences in interest rate setting between local banks and foreign banks, and between SOCBs and private banks. In these tables highlighted the interest rate spread between basic loans and deposits.

Table 8. Interest rates trend (2000-2004) **(%)**

	2000	2001	2002	2003	2004. 03	2004. 06	2004.11
Local banks							
Savings (US$)	3.0	2.0	1.5	0.8	0.3	0.3	0.25
Savings (kip)	12.0	12.0	15.0	13.0	6.0	6.0	5.50
Overdraft (OD)							
kip	30.0	24.0	24.0	28.0	24.0	25.0	23.33
baht	12.0	10.0	10.0	12.0	12.0	13.5	13.50
US$	11.0	11.0	11.0	11.0	12.0	13.5	13.50
Foreign banks							
Savings (US$)	1.0	0.5	0.3	0.3	0.3	0.3	0.3
Savings (kip)	-	-	-	-	-	-	-
OD kip	23.0	23.0	21.0	22.0	24.5	24.5	24.5
OD baht	17.0	17.0	14.0	14.0	13.7	13.7	13.5
OD US$	13.0	13.0	11.0	11.5	11.5	11.5	12.75
Spread local, kip	18.0	12.0	9.0	15.0	18.0	19.0	17.83
Spread local, US$	8.0	9.0	9.5	10.2	11.7	13.2	13.25
Spread Foreign, US$	12.0	12.5	10.7	11.2	11.2	11.2	12.45

Source: IMF (2004), Selected Issues and Statistical Appendix.

Table 9. Interest rate structure changes in 2004 **(%)**

		2004.02	2004.04-06	2004.07	2004.08-09	2004.10-11
Kip savings	SOCBs	8.0	6.00	6.00	5.67	5.50
	Private banks	7.0	5.75	5.75	5.75	5.75
Baht savings	SOCBs	0.3	0.28	0.28	0.28	0.28
	Private banks	0.38	0.38	0.38	0.38	0.37
US$ savings	SOCBs	0.3	0.25	0.25	0.25	0.25
	Private banks	0.37	0.28	0.28	0.28	0.30
Kip loans 1Y	SOCBs	18.00	16.67	16.67	16.67	16.00
	Private banks	22.33	22.33	22.33	22.33	19.30
Baht loans 1Y	SOCBs	6.75	6.75	6.75	6.75	7.67
	Private banks	13.53	13.53	13.53	13.53	9.20
US$ loans 1Y	SOCBs	6.50	6.50	6.50	6.50	7.50
	Private banks	10.30	10.30	10.30	10.77	8.40
Kip spreads	SOCBs	10.00	10.67	10.67	11.00	10.50
	Private banks	15.33	16.58	16.58	16.58	13.55
Baht spreads	SOCBs	6.45	6.47	6.47	6.47	7.39
	Private banks	13.15	13.15	13.15	13.15	8.83
US$ spreads	SOCBs	6.20	6.25	6.25	6.25	7.25
	Private banks	9.93	10.02	10.02	10.45	8.10

Source: Compiled from BOL data

In Lao PDR, commercial banks have to manage three currencies: kip, baht, and US dollars. As for the kip, the savings deposit rate seems to be unattractive for depositors, considering the current double-digit CPI level. And for the borrowers, the kip loans rate seems quite high. The government used to instruct SOCBs to provide preferential interest rates for agriculture and some politically important sectors (directed finance) a remnant of the mono-bank regime. This system has recently been eliminated by the

BOL due to its unsoundness.

The spread between loans and deposits is a crucial factor for determining bank profit and efficiency in banking operations. Table 8 and 9 indicates that some joint venture (JV) banks and foreign branches (private banks) seem to have wider spreads than do SOCBs. This is one reason why SOCBs have had difficulty resolving NPLs and focusing on profit making management. In 2004, the kip savings interest rate dropped gradually, but SOCBs maintained spreads of 10 to 11%. It is doubtful that banks can attract depositors when their real interest rates are negative. Interest rate will be determined in the market, affected by BOL's monetary policy, supply-demand condition for the loan, credit risks of the borrowers, and maturity of the loan, etc. It is said that the interest rate setting was liberalized, however, SOCBs' interest rate for the loans still seems distorted by the government.

In our interviews with potential bank borrowers, we heard complaints about high interest rates on loans, inconvenience in rolling over loans, and difficulty in attaining bank access outside of long-established good relationships. SMEs have difficulty accessing banking facilities due to their lack of valued collateral. Commercial banks should expand viable loan assets by solving those constraints to improve their profitability in bank operations.

2-5. Weak management capacity and human resources

In order to achieve sound operations in banks, good governance, adequate risk management systems and capable bank staffs are needed. The GOL recently provided SOCBs full autonomy, eliminating so-called directed lending, one of the causes of the accumulation of NPLs in the past. Our interviews with the various types of banks indicated to us a weak capacity of SOCBs in terms of risk management systems, worker skills, and overall banking service quality. It seems that SOCBs still maintain directed lending in practice. Foreign banks and JV banks seem to succeed in minimizing NPLs and producing profit in banking operations. Some private enterprises prefer JV banks or foreign bank branches to SOCBs due to their higher quality banking services for external trade financing. And contrary to what is expected, SOCBs are still producing NPLs despite strict supervision by the BOL. The old tradition of directed finance, defined as strong government intervention in banks' loan decision making, seems to persist in SOCB management. SOCBs can not accomplish restructuring by separating NPLs from their banks' balance sheets. They have to develop discipline in daily banking operations through autonomy from the government and learn and introduce modern risk management skills and banking services, and institutionalize them with trained capable staffs and managers.

3. Observation of the formal banking activities in rural cities

3-1. Recent banking operations at SOCBs' local branches

In rural province capital cities like Luang Prabang and Pakse, SOCBs have established branch offices to provide banking services locally. Foreign banks are not allowed to participate in local banking business. Our observations revealed the expansion of deposits at SOCB branches, indicating improvement of banking access for local enterprises and individuals in line with the growing and stabilizing macro economy. However, net lending has declined due to caution induced by strict BOL regulations that limit branch managers' decision making and suspend foreign currency loans which seemed to constrain the smooth fund mobilization locally. Characteristics of particular branches' operations are listed below.

- BCEL clients are mainly local large enterprises (number of clients: 50 to 100) that receive large amount of loans.
- LDB branches seem to expand rather local SMEs (number of clients: 400 to 500) via small amount loans.
- APB branches provide small preferential loans to village farmers without collateral (policy loans), and provide commercial loans to local SMEs, especially agriculture related businesses.

Table 10. SOCBs' branch profiles

.	BCEL (A)	LDB (A)	APB	BCEL (A)	LDB (B)
Branch staff	23	67	27	N.A.	N.A.
Decision making limit for branch GM	200 mil. kip	400 mil. kip	N.A.	N.A.	N.A.
Deposits (mil. kip) 12/2001 12/2002 12/2003 07/2004	18,942 35,706 50,300 70,365	N.A. 54,495 68,036 N.A.	N.A. 1,700 2,872 N.A.	48,114 55,297 66,105 88,015	42,689 50,936 77,940 93,328
Loan (mil. kip) 12/2001 12/2002 12/2003 07/2004	12,338 13,148 10,699 11,859	N.A. 19,804 13,995	N.A. 4,430 5,841	21,743 32,978 20,089 14,370	40,810 35,543 20,896 26,670
Loans/deposits ratio 12/2001 12/2002 12/2003	0.65 0.37 0.21	N.A. 0.36 0.20	N.A. 2.61 2.03	0.45 0.59 0.30	0.96 0.70 0.27
Loans, by sector	1. Trade 64% 2. Construction 22% 3. Service 9% (100 clients)	1. Trade 50% 2. Forest 25% 3. Construct 14% (400 clients)	Farmers 70% (4,188 households) Commercial 30% (133 clients)	1. Trade 50% 2. Manufacturing 13% 3. Agribusiness 5% 4. Contract4% (50 clients)	1.Trade 63% 2. Agriproduct18% 3. Handy-craft 9% 4. Construction 4% (503 clients)
Large scale clients	1. Construction 2. Fruits Trade 3. Wholesale 4. Beer 5. Gas station Top 10 share 50%	1. Mr. A ($0.12M) 2. Mr. B ($0.05M) 3. Ms. C($0.02M) Top 10 share 16%	Average $5-6000	1. Market (NPL) Top 10 share: 81%	1. Coffee plantation. 2. Motor bike 3. Oil 4. Contractor 5. Irrigation 6. Block maker Top 10 share 23%
NPLs	0.5% (2-3 Client)	9 billion kip (overdue 49%, 260of 400 client)	5.6%	66%	

Source: Interviews by Koyama.

3-2. Issues of financial access in rural cities (limited capacity of both lenders and borrowers)

In provincial capital cities, the demand for formal bank lending seems strong, both for working capital and for capital investment. The problem is that banking access for SMEs is limited due to the lack of capacity, both their own and the lenders. Borrowers are weak in business planning and submitting necessary financial documents for credit analysis. Lenders lack the capacity evaluating credibility of applicants. Modernization of corporate management will mitigate the existing mismatch between borrowers and lenders. A sound financial intermediary function with adequate risk management can not be achieved without improvement in human resource development in the banking sector. In order to improve the bank branches' sound operation, dissemination efforts of a variety of professional skills and knowledge necessary for managers and loan officers will be important.

4. Evaluation of the financial reform and a proposal for the establishment of DFIs

4-1. Scope of further banking reform

The government of Lao (GOL) has been focusing on restructuring of SOCBs' management and unsound balance sheets, aiming for them to become reliable commercial banks with advanced risk management systems and necessary capital adequacy. And now the GOL is considering the restructuring of the specialized bank Agriculture Promotion Bank (APB), separating policy lending for poor farmers from a pure commercial-based bank function. The GOL also proposes to establish a development financial institution (DFI) to support industrial and infrastructure development projects by supplying long-term loans. These and other reforms need human resource development, more strict governance structure and internal capital accumulation at banks. The SOCBs should speed up the restructuring of their balance sheets and improve the quality of their loan assets so they can become more profitable and sound. SOCBs and APB restructuring should be prioritized over creation of a new financial institution like DFI.

4-2. Aspects for consideration of DFI

In the various banking reform processes toward market economies, SOCBs in most transitional economies (e.g., Viet Nam, Cambodia, and even China) are requested to separate their policy-based loan programs from their commercial bank functions, and Lao PDR's will not be exceptions. However, in China the China Development Bank was established (1994) and in Viet Nam the Development Assistance Fund started operations (2000) with 100 percent government ownership to mobilize long-term funds to strategic industrial development projects and important infrastructure projects in line with government policy. Those DFIs are expected to play an important role for sustainable industrial development and economic growth in their respective countries, making use of their adequate risk management systems and autonomous status. Considering the issue of establishing DFIs in Lao PDR, we have to evaluate from such aspects as below:

- scope of work for DFIs (real loan demand in the business field, especially capital investment projects),
- availability of constant fund mobilization in a limited domestic financial market (aspect of funding resources for DFIs),
- establishment of a risk management system with professional skilled staff (aspect of human resources), and

- autonomy in decision making guaranteed, or not, by the government as a governance aspect.

(1) Need for DFIs

Regarding lending for private business, we observed some strong demand for capital investment. The privatized Lao Brewery has a capital investment project for production capacity expansion in a neighboring site. The state-owned Pharmacia (No.2) faces difficulty in expansion of production capacity due to lack of both internal and external funding. A wood processing company in Vientiane faces difficulty in borrowing money for new plant construction for facilities to process wood harvested from plantations. A state-owned telecommunications company borrowed long-term funds from China for network expansion, a kind of import financing scheme. These are examples of many capital investment projects identified over the short period of the survey. However, domestic SOCBs can not participate in those investment projects. Long-term financing seems to be difficult for SOCBs due to their short-term funding structure and currency risks. Thus, we recognized needs for DFIs or some sort of long-term financing function in urban areas, and for expansion of banking access (demand for micro credit) in remote areas. Since the urban cities clearly have business opportunities for commercial banks (demand for loans and their facilities), loan officers at SOCBs should make more effort to explore and cultivate viable borrowers. This is a marketing or promotion activity, and a common duty of branch staffs in Japanese commercial banks.

(2) Difficulty for long-term fund mobilization in Lao PDR

Under the current market condition of low domestic savings referred to above, it seems to be difficult to mobilize long-term funds for proposed DFIs. If the GOL causes an absorption of scarce domestic savings by issuing bonds to fund DFIs' activities, it may crowd out the private financing function operated by commercial banks. Under the country's fiscal shortage constraints, a low-coupon government bond would not attract investors, commercial banks or individuals. Balancing the fiscal budget and encouraging domestic savings should be prioritized over the establishment of DFIs. A commercial banking function for promoting private enterprises should also be a priority for the domestic financial market. Harmonization between commercial banks and DFIs should be promoted through complementary financial roles (e.g., commercial banks providing working capital, and DFIs providing long-term loans for the business development project). Furthermore, an adequate market-based interest rate setting mechanism should be introduced for further financial system development.

(3) Weak governance system and human resource development

The weak risk management system, persistence of directed policy lending, and lack of professional skilled staff are other constraints to DFI operations. Organizational structure, a governance system, and mobilization of management staff must be carefully discussed in a planning process.

(4) Lesson learnt from a Japanese DFI (failure of the predecessor to the Development Bank of Japan)

Since there are many failure case studies of DFIs in the world, we should learn from their experiences that are relevant to us. The bankruptcy of the bank causes fiscal burden that eventually imposes taxpayers burden. In Japan, a DFI established in 1946 just after World War Ⅱ, the Reconstruction Finance Bank (RFB), was dissolved in 1949 due to two failures. First, the government of Japan set up the top decision making committee with representatives from related ministries and BOJ, outside the RFB, who decided which projects to lend to. This directed lending produced NPLs, and corruption emerged. The second problem was mismanagement in the funding structure. The RFB issued guaranteed bonds. But they were underwritten by the BOJ and not issued in the financial market causing hyper-inflation in the real economy.

Those lessons are related to the issues of governance and market-based funding principles. Thus for Lao PDR, even though it is lacking domestic savings, its banks should mobilize available funds through the domestic financial market. At first, funding resources should not depend on external funds. Once a sound financial system is established in the country, external funding through two-step loan schemes will be available using a viable platform like DFIs.

4-3. Sequence of the establishment of DFI

As mentioned before, the banking system in Lao PDR faces many difficulties. Looking at the bank management failure of SOCBs', establishment of a new bank is not an easy task. However, I would like to conclude my report by indicating a rough sequence for the establishment of DFIs.

1st – Stabilization of the macro economy must be prioritized. Balancing the budget, containing inflation, and stabilizing the foreign exchange rate will contribute to mitigate market risks and provide a better business environment for SMEs. Interest rates can be determined based on the market mechanism, which gives entrepreneurs easier bank access. This also allows depositors to enjoy positive real interest on their savings at banks, which encourages domestic saving in the country. Financial deepening would be promoted in this process.

2nd – Strengthening of the short-term commercial banking function should be prioritized over attention to DFI long-term financing for capital investment projects, because, long-term financing faces higher risk. DFIs need more-advanced risk management systems and more-skilled human resources.

3rd – Monitoring achievement in the restructuring of SOCBs and considering the availability of market-based funding and human resources for DFIs will be proceeded. Since in the startup period, DFI funding is heavily dependent on the budget, the fiscal balance condition seems crucial. Once domestic savings is enlarged in line with increased credibility of the government and banking system, Lao PDR, like China and Viet Nam have done, might be able to mobilize longer-term funding by issuing DFIs' bonds in the market, guaranteed by the government. Since there is some risk of crowding out commercial banking activities, too much bond issue must be avoided. And DFIs' scope of business should be focused and clearly identified as being in harmony with commercial bank business. The projects targeted by DFIs must be bankable – that is, able to maintain sound operation. These are basic operational principles for DFIs.

DFIs' urgent introduction of modern accounting systems and risk management systems is crucial, as is their mobilization of capable managers with professional banking skills. Establishment of a banking school or JV with foreign banks may be some ideas to contribute to upgrade the quality of banking services and risk management structure in the banking business in Lao PDR.

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5. The Possibility for Establishing a Development Financial Institution in the Lao PDR

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Summary

The study on the possibility for establishing a development financial institution (DFI) in the Lao PDR was proposed by Lao team member of the Financial Sector Working Group under the MAPS II project. Generally, Chapter 1 of the study deals with the introduction, a brief rationale and the urgent need for establishing a new development financial institution in the Lao PDR. This section calls for the need of such an establishment based on some statistics on performance of the Agricultural Promotion Bank (APB), which pursues two roles—commercial and policy based—simultaneously. This leads to confusion and weak performance of the bank. The Chapter summarizes that the policy based lending activity must be separated from APB and that the establishment of the new specialized development financial institution is needed.

Chapter 2 of the study deals in more detail on problems of the APB, with a brief summary of the overall banking environment, performance, problems and on-going reforms. The Chapter discussed, again, the need to separate policy lending from the whole banking sector, particularly the APB, and let them operate on a commercial basis. The rationale for the separation is drawn from the analysis of data and interviewing survey conducted by the Lao study team and co-conducted by the Japanese experts in the Financial Sector Working Group. Chapter 2 also provides rationale for establishing a specialized DFI including (1) credit restraint, which is the situation where the formal banking sector is more cautious and subjected to limited credit expansion, which results in greater difficulty in accessing credit, even for short-term loan; (2) the need for long-term financing, which is drawn from the interviewing survey of SOEs and SMEs closely linked with bank financing; (3) private sector development and the need to finance the prioritized sectors, which deal with the rationale for the need of policy oriented lending to prioritized private sector and SMEs in order to indirectly speed up poverty reduction; and (4) other issues for the establishment a new financial institution responsible for both long-term finance, which is now missing in the current banking sector, and policy oriented financing. The Chapter also provides conditions and some findings for the sustainability of a new DFI, if it is to be established, based on the interviewing survey and experience of Lao bankers. In summary, there are many reasons for the establishment of a DFI. However, in order to make it sustainable under the current financial situation, many considerations or

conditions are needed to be met.

The last Chapter (3) presents basic conceptual arguments on whether there is an alternative or possibility for the establishment of a DFI in the existing financial system. The Chapter deals with both the supply and demand side of the financial institution, pointing out the concerns over the source of funds for the operation of the DFI and drawing on experience from the Japanese conceptual structure of a DFI. The Chapter also provides a conceptual framework of corporate governance issues, which can be applied to enhance the governance and functioning of the banks. With this regard, the best practice on board structure is provided. On demand side analysis, the Chapter points out in more detail about the possible prioritized sector, which will be clients of the DFI. Finally, the Chapter concludes that a DFI is one instrument that will play a role as intermediation, especially for long-term financing objective, but many factors and conditions still have to be taken into consideration, especially when looking at the current situation of the Lao financial system. Practically, further study on the real demand of credit of a DFI is needed to provide precise information on the cost and amount of demand.

5. The Possibility for Establishing a Development Financial Institution in the Lao PDR

Chapter 1: Introduction and Brief Rationale for Establishing the New Development Financial Institution in Lao PDR

The development financial institution (DFI) in the Lao PDR is a specialized bank in the formal banking system. This institution was established in 1993 with 100% registered government capital of 800 million kip. This development financial institution was named the 'Agricultural Promotion Bank' (APB), and it has two main roles. Firstly, the APB invests and provides credit based on government policy, especially to promote prioritized projects in the agricultural sector in the whole country, in line with the realization of the 20 year strategic plan (2001-2020) as annual plans. The investment of the APB is presented in terms of short- and medium-term credit provision for projects such as animal rearing, seasonal and irrigated rice plantation (short-term: 6–12 months); industrial tree plantation (medium-term: 3-5 years) and so on. These are the prioritized projects of the government and the ones in which the private sector can not invest. Secondly, the APB operates on a commercial basis as a secondary role by providing credit to agricultural sector, in order to ensure profit for the subsidizing policy based loan. Therefore, the APB has different operating mechanism and performance from other commercial banks in banking system.

In its past operations, the APB has performed well in terms of serving government policy. However, since the APB mobilizes public saving for commercial and policy based loan, there is concern that there is a high risk based on the financial status of the bank in the 2000s. Capital adequacy continued to be negative every year. Non-performing loans (NPL) increasingly accumulated every year. As a result, the APB has had to set aside a Specific Provision and General Provision for loan losses, which in turn has led to a yearly loss. By comparing financial performance of APB in 2001 with that in 2003, it showed that (1) the capital adequacy ratio increased from a negative percentage of – 36.8% to -46.2%; (2) Non-performing Loans increased from 129.8 billion kip (out of 192.3 billion kips loan outstanding) in 2001 to 138.7 billion kips (out of 235.3 billion kip loan outstanding) in 2003, with a specific provision of only 64.48 billion kips in 2001 and 96.58 billion kips in 2003; and (3) net profit increased from 21.67 billion kips in 2001 to 79.89 billion kips in 2003. In general, all mentioned figures could be analyzed and it indicates the risk of APB and points out the need to urgently improve.

Since the APB executes two main roles simultaneously—commercial and policy based roles—it creates internal confusion within the APB itself, particularly in the management role of the bank manager, which could be classified into three main tasks as follows: (1) planning and doing business, (2) planning for implementing directed investment, and (3) the determination of achievement, which cannot be classified into achievement from doing business and achievement from implementation of government policy. Although the above figures on the bank's performance have been analyzed, it is still unclear whether the poor performance stems from the direction of the government or from the bank manager of the APB.

Based on the aforementioned reason, there is a need to establish a specific development financial institution to implement only investment and credit provision to prioritized projects based on direction of the government, by utilizing the government budget and low interest rate fund mobilized from domestic and foreign countries.

Chapter 2: The APB problem and the need for Development Financial Institution

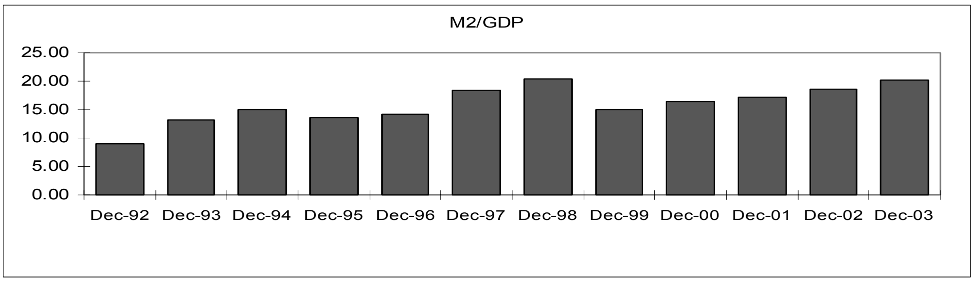
This section will discuss the issue of separation of policy based lending activities from the operations of the state-owned commercial bank, particularly the Agriculture Development Bank. The section will touch on the reason for maintaining policy based financing and find out what type of institution is needed to take care of policy based activities. Apart from that, the gap between long-term and short-term financing will be discussed, which again will add the long-term financing function to the new institution if it is to be established. Before going to the mentioned issues, especially the issue involving the APB's problem and constraints, the current environmental setting concerning the banking situation will be briefed and a review of on-going reforms will be discussed.

I. Overview: Characteristics and Role of banking sector, its problem and on-going reform

Some Characteristics

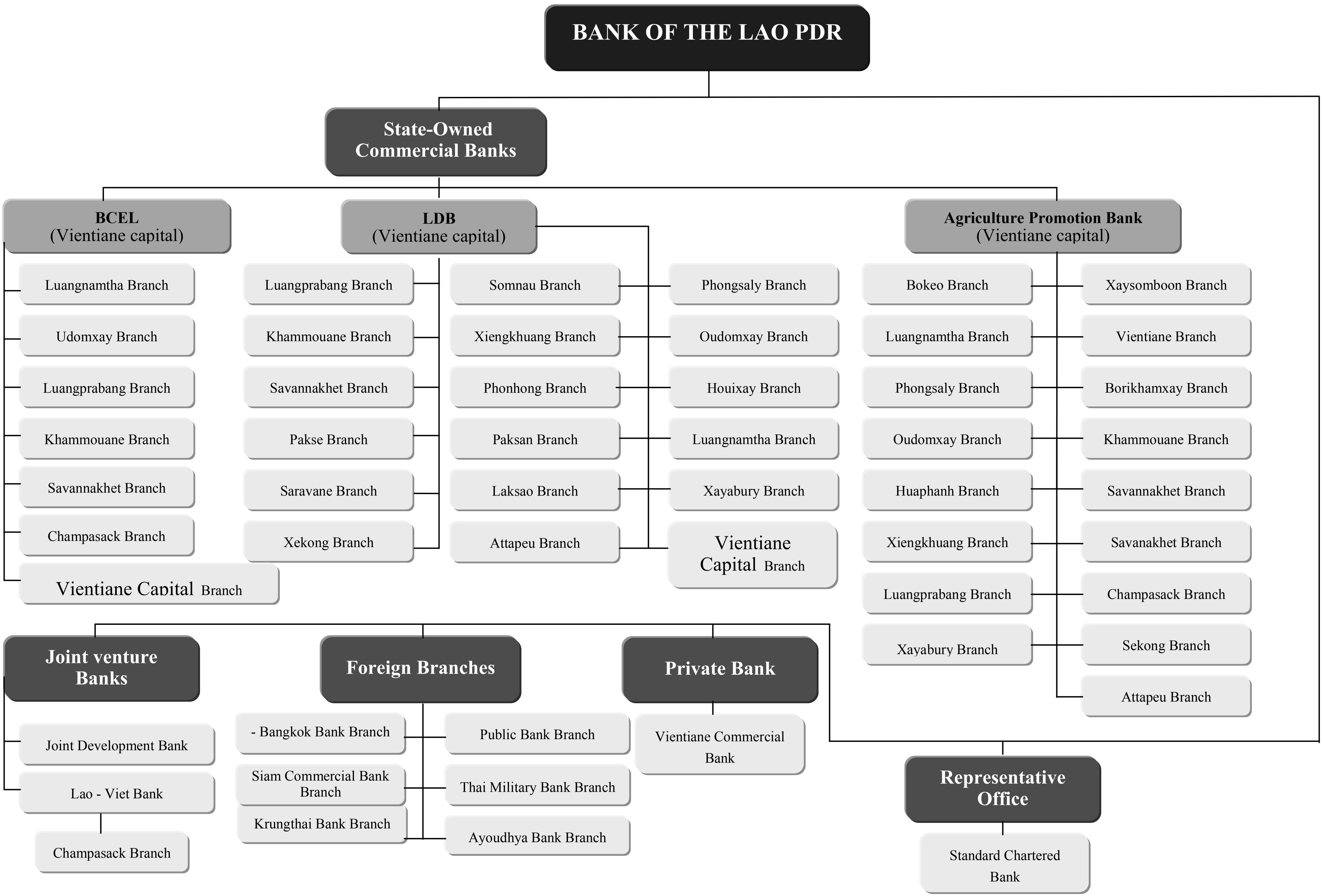
The financial sector in Lao PDR is dominated by banks, with one insurance company. As of now, the banking sector is comprised of the Bank of Lao PDR (the central bank), state-owned commercial banks, joint venture banks, foreign bank branches, a private bank and a representative office (See Figure 3). The banking sector is relatively small compared to other countries, with total assets of approximately US$400 million or about one third of GDP. The financial depth is also low represented by a low level of intermediary. The average ratio of M2 to GDP from 1992 to 2003 is approximately 16% (Figure 1). Financial services reach only a small part of the population, with only 11% of rural households borrowing and only 1% saving (ADB, 2002).

Figure 1: M2/GDP (%)



Source: BOL

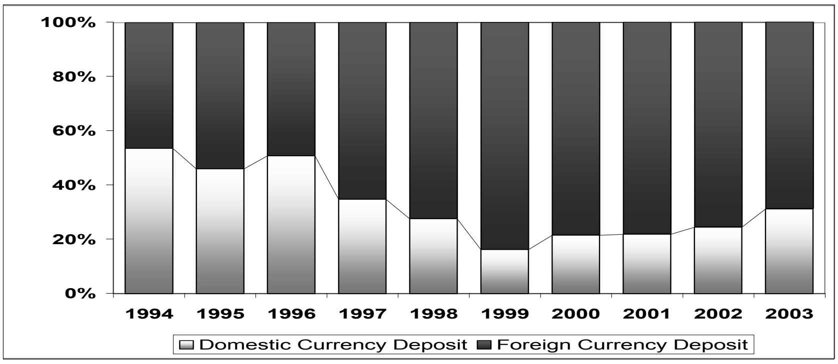
Figure 3: Lao Banking System



Source: BOL

Dollarization also characterizes the banking sector. Banking deposits are dominated by foreign currency, accounting for more than 65 percent on average (see Figure 2). The share of foreign currency deposits increased significantly from 1994 to 1998, reaching almost 84 percent in 1998. This reflected the lack of confidence in the kip.

Figure 2: Dollarization in banking account



Source: Computed from Table 1

Compliance with function of banking sector

As cited in literature, a healthy financial system is essential to economic development and growth, it serves a particularly important role in channeling domestic savings from those who have a surplus of money to enterprises for financing investment or to those who lack funds. As of now, the financial system in Lao PDR is keen to serve that role, but it is constrained by low domestic saving and credit restraint resulting from the chronic NPL problem due to the past operations. Although saving in the banking system has been showing a positive trend over the last 10 years (see table 1), the degree of channeling such saving to investment loan is still low. At the end of 2003, deposits in bank accounts amounted to 3,832.49 billions kip or US$365.71 million[1], while domestic credit amounted to 2,323.4 billion kip or US$221.7 million, which accounted for only approximately 60% of total deposits.

Table 1: Deposits at commercial banks at the end of period (Billion Kip)

	1997	1998	1999	2000	2001	2002	2003
Demand Deposit	26.62	105.82	141.19	271.80	263.00	358.20	436.68
Time and Saving Deposit	96.35	116.18	98.15	199.70	307.70	452.30	761.82
Foreign Currency Deposit	229.72	580.77	1,227.37	1,712.70	2,028.80	2,490.10	2,633.99
Total Deposit	**352.69**	**802.77**	**1,466.72**	**2,184.20**	**2,599.50**	**3,300.60**	**3,832.49**

Source: Bank of the Lao PDR

[1] End of December 2003 at Kip/US$ rate of 10,479.5

According to the interviewing survey with banking officers of the three SOCBs[2], the loan-deposit ratio for bank head quarter and branches is low (less than 25%), except for the APB branch (For BECL headquarter: loan is 30-40% of total asset). In addition, credit to the private sector compared with total deposit shows a decreasing trend to 38.6% at the end of 2003 (Table 2). This indicates that the banking sector in general is not playing well the role of financial intermediation, and there is a need to improve such a role by channeling financial resources to effective uses.

Table 2: Domestic credit as at the end of period (Billion Kip)

	1997	1998	1999	2000	2001	2002	2003
Domestic credit	362.26	704.53	1045.12	1439.3	2434.9	2559.2	2323
Credit to the economy	405.99	756.37	1317.34	1858.98	2553.5	2638.1	2454.4
Credit to state enterprises	120.42	223.55	445.39	606.4	1021	1133	974.1
Credit to private sector	285.58	532.82	871.94	1252.58	1532.4	1505.1	1480.3
Domestic credit/Total deposit	102.71	87.76	71.26	65.90	93.67	77.54	60.61
Credit to private/Total deposit	80.97	66.37	59.45	57.35	58.95	45.60	38.63

Source: BOL and NERI estimates

Current problems and ongoing reform

State-owned commercial banks' performance since the first recapitalization in 1994 has generally fallen short of expectations. The accumulation of NPLs continued to increase during 2000 and 2001, and the three SOCBs continued to generate losses. This showed that the past restructuring had not yet brought soundness to the banking sector. The problem in the banking sector stemmed from credit indiscipline of banks and borrowers, weak implementation of prudential policy and regulation and weak enforcement of the law.

In addition, macroeconomic instability in the past, especially the impact of the Asian financial crisis led to banking problems. The Asian crisis impeded the improvement of the SOCB financial position through debt overhang from macroeconomic instability prior to 2000. Since there was a sharp depreciation of the exchange rates during the crisis, it resulted in local firms not being able to service their foreign exchange denominated loans, which led to defaults in foreign currency loans. This also led to a fiscal problem, especially in revenue collection and the debt creation. Moreover, the effort to stimulate the depressed economy led to a huge amount of investment, while the management of public investment was still weak. This investment needed a lot of bank financing and led to accumulation of debt in the banking sector. In addition, a wide range of fundamental institutional weaknesses ranging from limited human resource capacity, especially in terms of credit analysis and risk management, inadequate information technology, to a lack of continuous coordination between bankers and customers also contributed to the weakness of banking sector.

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[2] The small interviewing survey on banking situation was conducted in August 2004.

Moreover, a lack of understanding and weak implementation of Decree 01/PM on decentralization made it more difficult to manage and monitor public investment. This put burdens on government budget which in turn affected banking sector. Specifically, weak monitoring and management of public investment led to the so-called 'Triangle Debt'. In the period of fiscal difficulties, when loans were due, the central and provincial authorities could not precede the payment to bank customers for government contract projects. This in turn contributed to the stock of NPLs.

Therefore, the highest priority issue in banking sector development is to stop losses in state-owned commercial banks, resolving NPLs and restructuring their operation on commercial lines. Other developing issues include strengthening the legal framework and judicial capacity to ensure law and contracts enforcement and capacity building for staff in central and commercial banks. Moreover, competition in the banking system will be enhanced by equalizing minimum capital requirements for banks with domestic and foreign shareholders, and allowing foreign bank branches to operate on a nationwide basis.

With the support of the ADB, the World Bank, the European Union, and the IMF, the government has begun to implement its banking sector reform program to secure operational improvements in the SOCBs based on the aforementioned. Hence, reforms of the state banking system are moving forward. The restructuring plans call for significant operational improvements over 3-4 years supported by international bank advisors and monitored in relation to performance targets, with the first test at the end of September 2003. Based on such a restructuring plan, the banks have strengthened their credit management and four international banking advisors were appointed to assist in various areas, including credit appraisal. In addition to SOCBs' reform, few advances were made in reforming the debt-burdened state-owned enterprises, which needed to be restructured to reduce their NPLs, a move that would complement the banking reforms.

According to the report by the World Bank (2004)[3], currently, SOCBs are advised by the Bank Restructuring Committee to follow their permanent credit policies as stipulated in the Governance Agreement. With this regard, the Department of Banks and Financial Institutions Supervision in the Bank of Lao PDR issued a notice No.172/BFSD in July 2004 to withdraw instructions 01 and 03 that imposed credit restrictions on SOCBs, especially in the areas of the lending limit to a single or grouped borrower, the limit to a foreign currency exposure, the branch lending limit, and the lending restriction if the SOCB's NPLs exceed 15 percent. This means that the banking sector can just now resume its lending activities based on a permanent credit policy after pausing in May 2002

Progress so far, based on available evidence, indicates that the share of NPLs in loans has been falling

[3] The World Bank Economic Monitor, November 2004.

in 2003 even though it needs to be brought down further. In terms of improving competition among commercial banks in Lao PDR, the amendments to the Decree Law on Commercial Banks, which has the objective of lowering the barriers to entry and expanding non-state-owned banks, will be submitted to the Standing Committee of the National Assembly soon.

In general, the banking sector is in the process of restructuring, which results in more strict lending activities, and in turn greater difficulty in accessing banking service by private enterprises. The bank for external trade (BCEL) and the Lao Development Bank (LDB) are now running on a commercial basis with no intervention from the government, and are in the process of strengthening and improving banking soundness. However, the Agricultural Promotion Bank (APB) is in a more severe restructuring process, as policy based finance is still imbedded in the current banking operations. The government is considering a proposal to separate commercial lending and policy lending within the APB. Another option has also been proposed, which is to fully separate policy lending activities from the APB and establish a new financial institution fully responsible for policy based activities.

Therefore, the following topic will touch on historical background of the APB, its operation, performance and issues that lead to the need to separate policy lending from the APB.

II. The need for the APB to be a fully commercial bank

Brief profile of the APB

The Agricultural Promotion Bank was established in June 1993 by the Prime Minister's Decree No. 92/PM as a development financial institution specializing in the agricultural area. The establishment of the bank was done by consolidating agricultural loan portfolios and the staff of the three SOCBs that provide credit to the agricultural sector. Initially, there were 53 staff members, of which 17 were female. The APB started to extend its network by establishing two branches in Bolikhamxay and Vientiane Province in 1993. The number of staff increased significantly to 676 members of staff (202 female) in 2002. By the end of 2002, the number of branches also increased to 17 branches in provinces. At district level, the APB had 55 District Service Units. The APB has three roles: first, to be a policy bank by, for example, lending at subsidized a rate under government instruction; second, to provide subsidized credit to private farmers on an arm length basis; and third, to fulfill the role of an agriculture promotion agency in importing and providing fertilizer, hand tractors and equipment to borrowers. In this latter role, APB also distributes in-kind donations from bilateral and aid agreements, on behalf of the Lao government, by getting a fee for such service. Since the focus of the APB is on the agricultural sector to which most of the population belongs, it is the only institution in the formal banking sector that provides financial services of any significance to the rural households.

Conflict between two objectives: commercial and policy banking

As mentioned before, the APB has to pursue three roles which could be considered as part of the two main objectives: first, its policy based objective i.e. to serve the government policy in channeling loans or services to prioritized development projects, and second, its commercial based objective i.e. to act as the common commercial bank based on the market mechanism. It is not only a bank, but also an agriculture promoting agency by strictly following the directions of the government, which is, for the large part, sacrificing the market principle, important for sustainability of the bank. As a development bank, the APB provides credit according to the priority plan of the government, covering areas such as food production, commercial production, rural development, and buying agricultural products, which will contribute to poverty reduction objective. These are valuable objectives and very important in the early stages of development where access to credit from such areas is difficult and costly if relying only on commercial banking activities. However, by carrying out the two main objectives at the same time, it is difficult to achieve them simultaneously.

Theoretically, the first best banking policy is to let a bank operate purely under the market mechanism. If following the direction of the government on lending policy, banks are then not autonomous profit-seeking entities, but operate as a quasi-fiscal mechanism, differing from the budgetary office only in the degree to which the fund employed can circulate, rather than being an out-and-out grant. To be optimistic, it may be the second best policy where, at the same time, the market based mechanism is pursued and the development goal is achieved. This is where the APB should pursue, however, as a bank carrying two objectives at the same time, this may not be appropriate, especially for the financial institution, which needs not only the market principle, but also the autonomy in its operation.

Performance and the need to be fully commercialized

Let alone, the APB operating on a commercial basis is more favourable for the sustainability of the bank. Since the APB is a specialized bank focusing on the agricultural sector in which most of poor people live, if the APB can operate based on commercial basis more effectively than on a policy oriented basis, commercializing the APB will benefit rural people and, at the same time, improve sustainability of the bank itself.

Based on the interviewing survey with the banking authority in November 2003, it revealed that, on the liability side, around 60% of the APB's portfolio is funded by BOL, the Ministry of Finance, provincial budgets and loans from donors i.e. EFAD, EU, etc., while the rest is from public saving. Practically, the fund from public saving was channeled to borrowers based on a commercial basis, while BOL and donor sources were used based on policy oriented lending purposes. The performance of such two-objective base operations resulted in accumulation of NPL, mostly from the policy lending activity. According to the interview in April 2004 by the Lao side working group, the NPL from the BOL and donor source accounted for around 60%, while NPL from public saving source, which was mainly utilized based on a commercial basis, accounted for 30%. Another survey in September 2004 by the Japanese working group revealed that the APB branch, with 50% fund from the government and the rest from public savings, had NPL of 80% from government funded sources and only 7% from public savings sources. This showed that the commercial lending activity performed better than policy based lending. Therefore, this confirms the need to phase out policy lending or find alternative ways to separate such activities from the APB.

Moreover, the APB is better equipped to evaluate agricultural loans than SOCBs, which predominantly operate in urban areas and do not have the outreach or the expertise to evaluate such agricultural loan. However, because of the special characteristics of the APB, the bank is facing the risk generated by the vulnerability of agricultural sector, particularly the fluctuating nature of yields. This calls for a higher risk premium than the policy based loan could offer. In addition, as the focus of the APB is on the agricultural sector, which located mostly in rural areas with limited infrastructure, particularly roads, electricity and telecommunication, the cost of being the financial intermediation and acquiring information on borrowers is even higher than usual banks. Therefore, relying on policy based loans is not sustainable for a specialized bank like the APB, and there is a need to be fully commercialized to cover such a risk premium and additional costs in order to provide loans to poor farmers in rural and remote areas.

Measure taken so far

Currently all SOCBs have undertaken the banking restructuring process by phasing out policy based lending. BCEL and LDB are now running on a commercial basis without interference of policy based lending. This will also apply to the APB which is mostly involved with policy loans. The experience gained from past operations of the APB prove that the there exists inefficiency when there are two main objectives, commercial and policy based, which are implemented at the same time and which, to a large extent, confuse each other. Therefore, the Agricultural Promotion Bank is now in the process of transforming itself into a self-sustainable, market-oriented rural financial institution. Policy-based lending is being phased out in favour of strictly commercial criteria.

The interviewing survey with the APB in April 2004 reveals that, according to job specification under the MOU signed on 05/12/2002, International Banking Advisors proposed the plan to phase out policy lending from the APB within 3 years (not exceeding 31/12/2006). All policy based loans from central and local government sources will be transferred to off-balance sheet and registered in the account of the fund owners. APB will continue to manage policy based loans on behalf of fund owners (government, BOL, provinces, etc.) in exchange of a reasonable administrative fee and profit spread. The conditional loan from international donors such as ADB, EFAD and EU, will be maintained in the balance sheet of the APB until the expiration of loan contract. The APB will stop receiving policy based loans from government organizations such as Ministries and provinces from this year, except from BOL. The policy based loans from BOL source could be continued in the off-balance sheet, but the BOL would ensure an administrative fee and reasonable profit for the APB. However, this policy based loan will be phased out by the end of 2006, in order to give time for the government to find alternative non-bank policy lending mechanisms.

This leads to the question of whether there is a need for a new development financial institution that will take full responsibility for policy lending and be equipped with a long-term finance objective based on the real long term demand for the fund (which will be explained later in next section).

III. The need for a development financial institution

As mentioned before, the Lao government is now considering the separation of the policy lending activity from the operation of the APB and the establishment of a new development financial institution (DFI), replacing the policy based role of the APB. This initiates the study on the possibility for such establishment. Therefore, the following will discuss issues and reasons for the DFI initiative.

1. Rational and Issues

Credit restraint

As discussed in the previous topics, there are many constraints in the financial sector that hinder its development and limits access to the banking sector by potential borrowers. The small size, low saving mobilization, weakly performed lending activity, NPL accumulation, and limited outreach contribute to the existence of the current banking problem. The macroeconomic, legal and judicial environment also magnify the problem. This is why many phases of banking restructuring and reform have been taking place. All of these reforms address the problem in many aspects, all of which aim to create soundness in and strength the Lao banking sector. However, before the soundness is established, past lending activities were revised, as they resulted in the accumulation of non-performing loans, which created the current burden on the banking sector development. As a consequence, credit restraint was put in place since May 2002 as a prompt action to stop accumulation of NPLs. Therefore, banks and branches are subjected to strong restrictions imposed by the BOL and international advisors such as ADB, IMF and WB. This restriction is a good remedy for addressing NPL problems and unsound banking activities of the past, but it also limits the role of the bank in channeling resources from depositors to borrowers, which in turn affects the productive activities contributing to growth of the country.

The need for long-term finance

In general most of the surveyed SMEs need not only working capital, but also long-term capital for their business extension and long-term investment activities. While funding demand for both short-term and long-term is increasing, acquiring a loan from the formal banking sector is much more difficult than in the past, as the banks are subjected to many conditions from BOL and international banking advisors, and have to be more cautious on their lending to avoid the re-emergence of NPLs. Therefore, banks at both the central and local level can only provide short- to hardly medium-term loans. With the maturity constraint on-lending for longer terms and lower interest rates through the government, especially for state-owned enterprises, are observed. Examples from the survey can illustrate this. Capital for machinery and development of Water Supply Company of Luangprabang is financed mostly by loans from the ADB, Germany and counterpart funds from the government. One cement factory under DAI (State enterprise for Agricultural and Industrial development) is also financed by a Chinese fund guaranteed by Lao government. ETL (State Own Telecommunication Company) also finances its investment by loan in-kind (equipment) from China.

For other private or joint venture enterprises, utilization of short- to medium-term financing from the Lao banking sector is also observed, but that also required a historically good relationship with the banks for medium-term loans. The market construction project of DPLCP Group in Luangprabang is partly financed by a loan from the LDB with 8 years maturity, providing that this company has good performance and a long relationship with the bank. However, most other enterprises could access only a 1 year loan from the bank. With the need to finance fixed capital with longer term loans, the companies sometimes use short-term loans to finance long-term investments, which results in NPL and loan restructuring. The Rama company (hotel and agricultural product collection business), for example, experienced financing machinery through 1 year loan, but then resulted in loan restructuring to 3 years maturity. The P.V Garment factory financed its investments by loan from the World Bank for its establishment, but than utilized short-term loans for its working capital.

Private sector development

In the Lao PDR development context cited from development strategic documents, namely the National Growth and Poverty Eradication Strategy (NGPES), the private sector is believed to play a very important role in the country's development. Moreover, since Lao PDR is now moving forward to regional integration (being a member of ASEAN and AFTA, and recently applying for WTO accession), private sector development will also play an important role in the process of delivering meaningful integration through foreign trade and investment. Since the Lao private sector is dominated by small, medium and micro enterprises, measures for providing financial supports to ensure strong development of this sector is the most efficient method of contributing to economic growth, of which benefits are shared across the entire population through employment and income generation.

However, the banking sector, which is supposed to act as a main contributor to economic growth through financing SMEs development, is still facing development challenges in terms of increasing robustness and sustainability. The current banking sector does not yet fully serve the role of financial intermediary, especially in response to a wide range of demands for financing the private sector, both in terms of volume and maturity. Most private enterprises, mainly SMEs, need long-term capital for financing long-term investment. But financial institutions which can provide long-term financing do not yet exist in Lao PDR. Therefore, long-term finance institutions are needed

The need for prioritized lending

As stated in the National Growth and Poverty Eradication Strategy, poverty reduction is one of the most prioritized objectives. Under the credit constraint environment, the poverty reduction objective is difficult to achieve. On the one hand, measures related to rural and microfinance development initiatives will constitute the more direct contribution to poverty reduction, while creating market discipline at the micro level. On the other hand, small and medium-sized enterprise development will also contribute indirectly to poverty reduction. To hasten such development, policy oriented credit or indirect subsidies are still needed, particularly for prioritized SMEs or private enterprises that are closely linked to improving the living conditions of poor people. However, the prioritized sector needs to be clearly defined to avoid the confusion and overlapping with other private sectors that seek funding from the formal commercial banking system.

Rationale for policy oriented

If the government can afford the subsidy for a particular development objective, rather than providing a direct subsidy, the use of a financial instrument (loan) with preferable terms and interest could encourage market discipline and the effective use of money. Direct subsidies are like free money for production which the receiver could use in line with a proposed production plan under the prioritized area of the government. However, because it is a subsidy without a commitment to return, this may result in misuse or ineffective use of money. Meanwhile, an indirect subsidy through a preferable interest rate loan places restrictions on the receiver to payback and to be more responsible for the use of the money, which will, in turn, create efficiency. However, policy or preferable loans provided by the development financial institution must be attached to prudential supervision and risk management to ensure the effectiveness of such indirect subsidies and avoid a burden on the institution's balance sheet. Again, this requires a specialized bank (not the APB), called a 'development financial institution' by many developing countries, to take care of such policy loan.

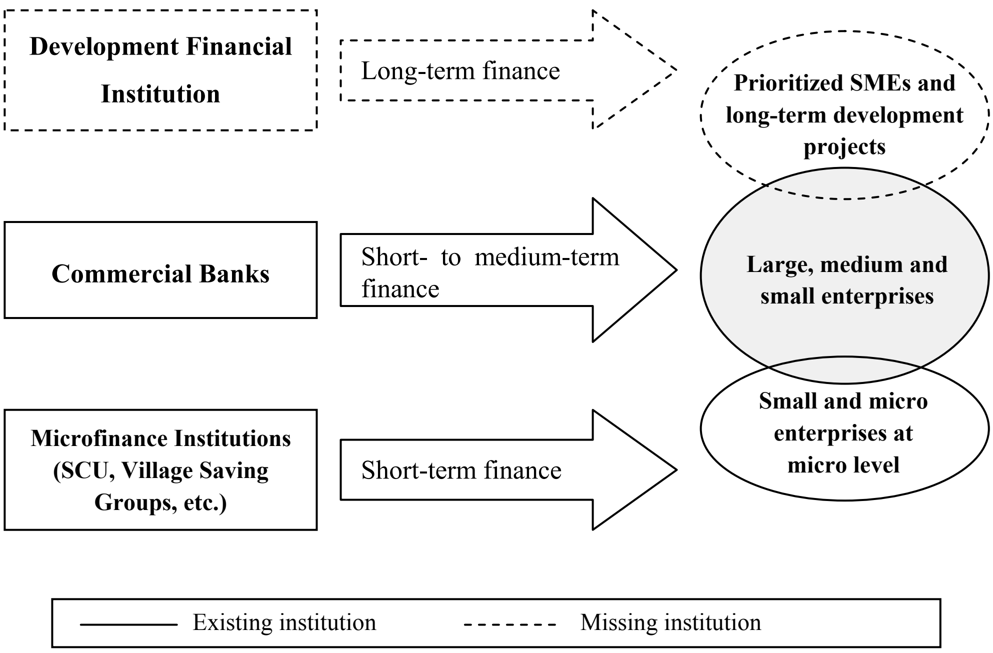
Some may argue that subsidies should be in other forms, rather than a soft loan. It should be provided to help the poor to get out of poverty and be able to develop entrepreneurship and access credit for their business development. Although this is a valid argument, as mentioned earlier, subsidies could be channeled not only to assist the poor directly, but also to encourage existing entrepreneurs or SMEs, under a precisely defined prioritized area, to grow substantially, especially in an environment where credit access is very difficult.

Therefore, the use of policy based loans in well-organized and specialized development financial institutions may be one option to promote development of SMEs under prioritized areas of the government and to enhance the poverty reduction objective. Under the process of bank restructuring where APB is transforming to a fully commercialized bank, more specialized development financial institution is even more needed for achieving aforementioned objective.

The missing gap

In Lao PDR, there is still a limited variety of financial institutions suitable for the different types of financial purposes and customers. A number of financial institutions exist (ranging from commercial banks, postal saving institutions and microfinance institutions), and each type of institution targets different kind of customers, ranging from government and private enterprises, small and medium enterprises, farmers to general public and poor people. However, commercial banks including the APB could mostly provide short- to medium-term loans, while microfinance institutions are just in an early stage of development.

Figure 4: Filling gap of long terms demand



As illustrated by the figure above, a DFI could fill the gap in long-term financing for SMEs under the prioritized areas of the government. Basically, large, medium and small-sized enterprises all have high demand for both long- and short-term financing. However, the DFI, in its initial stage, will provide only long-term finance for some prioritized sections of SMEs, since the source of funding will be constrained by the government budget and lending from donors. The DFI will serve long-term financing objectives as long as a more advanced financial market is developed and there are means to directly mobilize domestic long-term savings for the long term-financing of enterprises.

2. Condition for sustainability of DFI

The justification for the establishment of a DFI will rest not only on the reasons for the lack of it, but also on the conditions to make it sustainable (with no repetition of unsound operations experienced in the past), if it is to exist. Based on the interviewing survey on the possibility for establishment of DFI, some conditions have been proposed. Firstly, the DFI should channel resources only to productive sectors. Secondly, the DFI should have autonomy in terms of credit decision-making. Since the objective of the DFI is to realize the government development policy, the broad areas of resource users shall be directed by the government. However, the detailed screening and credit provision to individual borrowers under the broad areas set by the government should be under the decision and responsibility of the DFI. By doing so, the DFI will realize government development policy without sacrificing its role as an intermediary that channels resources to efficient users. Thirdly, the source of fund for the DFI must be on a long-term basis, as it provides long-term credit. This will prevent maturity mismatch and risk. With this regard, short-term deposits from the public should not be used. The potential source of funds may include the pension fund, the welfare fund, voluntary NGO's fund and other long-term low or zero interest sources. This will ensure that the burden of bad debt, if incurred, will not affect a short-term depositor, which is, in turn, related to credibility and reliability of the bank.

In addition, some concerns were also raised in the survey on the establishment of the DFI. The major concern is how to mobilize funds for such an establishment and its operation. Considering the current budget deficit together with a still-weak banking system and the low capacity of the bank staff in risk management, it is difficult to mobilize budgetary sources and skilled staff for the operation of a DFI. This would be possible only if there is foreign support.

Regarding such concerns, the following conditions were also proposed by SOCBs' branches based on their past experiences for the sustainability of the DFI in conducting policy based financing.

- There should be skilled human resource available for the new bank. This includes capable, experienced and skillful managers in managing the banking business, and skillful and experienced staff in dealing with risk management.

- The credit policy should be prudent and enforceable, together with strong institutional framework as well as law enforcement.
- The DFI should have autonomy in administration, credit decisions and interest rate determination. That is to say that the DFI should not be focused on receiving orders or commands regarding resource distribution, but be able to reject unproductive projects.
- Project monitoring must be frequent and strict to ensure that the fund is channeled to the right target.
- Determination of the credit priorities of the government must be consistent with the real needs of people, not on a mobilized basis. Resources must be channeled to appropriate and good conditions, and to prepared areas or targets. Classification of a production zone should be appropriate in terms of geography, readiness and willingness of people and supportive local authority.
- Promotion policy must be consistent, continuous and on a long-term basis in order to avoid a waste of the resources provided by the DFI. It was seen from the past that some projects could mobilize funds to finance only fixed costs, but could not access credit for operational cost as a prioritized area, and technical support was also turned away to other directions.
- Triangle debt must be avoided. Since the sustainability of qualified SOEs as well as SMEs under government priorities requires sustainability of the DFI which will provide them with long-term credit. Therefore, there should be a mechanism or planed budget for paying back long-term government debt to SOEs or SMEs who take up government projects on a time schedule, so that they can pay back the DFI on a long-term basis.
- A particular training course should be provided to borrowers from the DFI, e.g. on accounting and business management, to enhance business efficiency of the DFI's customers in order for them to be able to pay back the loan.

These are proposed conditions and issues for the sustainability of the DFI. Apart from that proposal, funding sources of the DFI is of an urgent concern. However, if the government can mobilize resources and fulfill the aforementioned conditions, the DFI will be a means for financing the growth of the country and contribute to the poverty reduction objective.

Chapter 3: Possibility for Establishing a Development Financial Institution

This part will present basic conceptual arguments on whether there is an alternative for the establishment of a development financial institution (DFI) in the existing financial system of Lao PDR or whether it would not possible to do so in the early phase of the current financial reform. It will also examine how to approach the situation, in supporting the fundamental requirements for the establishment of the DFI. The central questions addressed here are, firstly, what sources of funds are available in the financial system of Lao PDR and how would it absorb those funds; next it is necessary to examine the real needs of demand for capital of DFI and the potential of existing firms in the Lao transition economy; lastly it is important to touch on what kinds of cooperative governance institutions are best suited for the existing financial system and what can be expected from the DFI in early stage, and discuss what can be done to improve them and how they function.

I. SUPPLY SIDE ANALYSIS AS SOURCE OF FUNDS

A lot of literature and empirical evidence suggest that for the early phase of the economic transition, internally generated funds will be the most important source of financing (Erik BerglÖf 1995). This is because the costs of external financing are likely to be particularly high, given weak outside institutions and legal framework. Thus, we will list major internal funds that are available at current financial system and examine them closely.

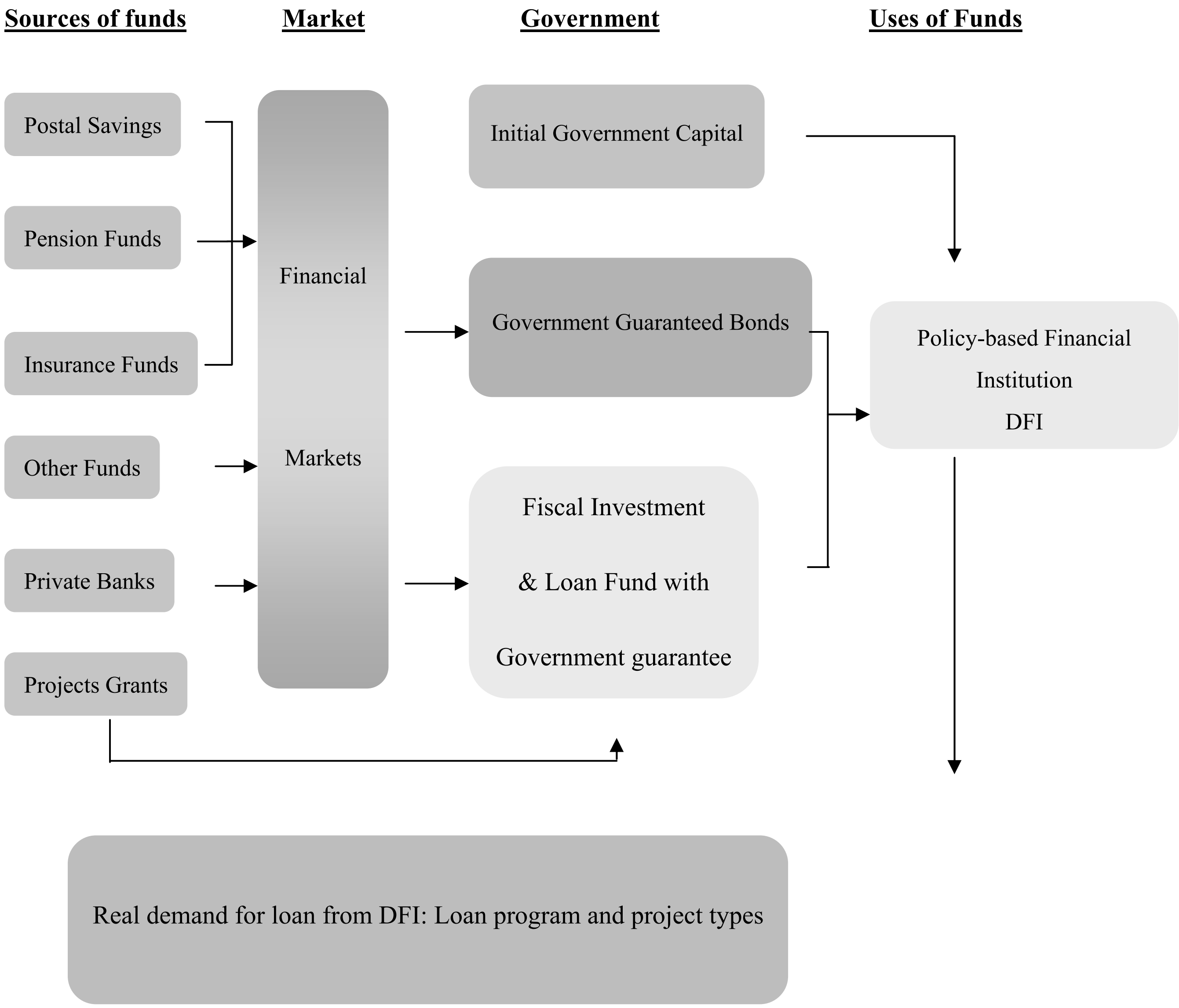
Those internal sources of funds that were available in the financial market are invested in the short-term in commercial banks. This is likely to happen because there is only one way that those funds can be secured to gain benefits from their short-term interests under the existing financial system and the uncertainty of macroeconomic stability. The remaining question is how to absorb those funds. These funds will flow into the fiscal investment and loan program only if there is profitable, credibility of the financial institution, including sound governance and transparency of the projects that were lent to.

With the extreme situation of the financial system of Lao PDR, there are still external funds that are currently available, which either previously flowed through the agricultural promotion bank (APB) or operated alone in the fiscal budget account and were lent to specific programs for policy development of Lao PDR.

Of course the question would be how to mobilize this in an efficient manner. A lot of literature and empirical evidence suggest that most of the external funding will have to come from control-oriented financing (Erik BerglÖf 1995). In other words, we must either issue contingent ownership rights to asset and cash flows or give up some control over investment decisions. Under the control-oriented financing, donors have control rights to force the implementation of efficient decisions. Due to the existing financial system, markets for real assets will remain illiquid because of strong insider control and poor enforcement of property rights. Therefore, the improvement of governance and facilitation of transfer of real estate are particularly important objectives to develop.

Under the current condition of low domestic savings, it seems to be difficult to mobilize long-term funds for the planned DFI. In the early phase of establishment of the DFI, if the government forces absorption of domestic savings by issuing bonds to fund the DFI activities, it may crowd out the private financing function. Under the country's fiscal shortage constraints, a low coupon government bond would not attract investors, commercial banks or individuals. Balancing the fiscal budget and encouraging domestic savings should be prioritized over the establishment of DFIs. A commercial banking function to promote private enterprise is also a priority for the domestic financial market. However, the only way for first phase of the government's tasks would probably be to inject some amount of capital to the DFI, since the stock and bond markets are not going to play a major role in the provision of funds during early phases of economic transition. The empirical evidence suggests that promoting the liquidity of stock and bond markets is of second order compared with the promotion of liquidity in markets for real assets.

The empirical lesson that can be draw from the Japanese experiences is the conceptual structure of raising funds from the public and private. The diagram below illustrates the possible process of raising fund for DFI:



The diagram illustrates that the government can borrow directly from the internal available funds in the financial market by issuing either directly long-term (10-15 years) bonds or guaranteeing long-term policy-based financial institutions a fixed low interest rate. However, the funds can be absorbed from the market if the financial market is working properly. In addition, it will require sound financial management, macroeconomic stability and a suitable legal regulatory framework and law. It is a very crucial step that should be addressed. Next is what kinds of governance institutions are best suited for this developing model. So, the next section will identify the basic governance institution issue, function and scope of activities and administration mechanism.

II. CORPORATE GOVERNANCE ISSUES

Research suggests that well-functioning banks promote growth[4]. When banks efficiently mobilize and allocate funds, this lowers the cost of capital to firms and accelerates capital accumulation and productivity growth. Furthermore, banks, as major creditors and in some countries as major equity holders, play an important role in governing firms. Thus, if bank managers face sound governance mechanisms, this enhances the likelihood that banks will raise capital inexpensively, allocate society's savings efficiently, and exert sound governance over the firms they fund. Nevertheless, little is known about which laws, bank supervisory strategies, and bank regulations enhance the governance and functioning of banks.

The problem of enforcing agreements obviously extends far beyond corporate governance. Nobel Laureate Douglass North (1991) argued that "how effectively agreements are enforced is the single most important determinant of economic performance." Recent research supports this assertion, suggesting that enforcement of the rule of law is a, perhaps the, central functional difference between developed market economies and developing economies. Indeed, according to some analysis, the development of countries as well as their vulnerability to external shocks can be explained by the degree to which private property rights are being respected (Acemoglu, Johnson and Robinson, 2002). Comparisons between developed market economies and transition economies also show much larger differences in enforcement (law effectiveness) than in laws in the book (law extensiveness) (Pistor, Raiser and Gelfer, 2001).

While enforcement is a general problem of development, it particularly affects firms seeking external financing. Financial contracts after all involve the commitment of the firm to adhere to certain obligations, in particular to pay an appropriate rate of return to the providers of external financing. A weak enforcement environment makes it more difficult for firms to commit to honoring financial contracts and attract external financing. Again, it is not only the laws, but their enforcement that affects the ability of firms to attract external financing and, consequently, the degree of general financial development. Empirical evidence, for example, shows that it is not the presence of insider trading laws, but rather actions taken against insider trading that help explain the development of securities markets (Bhattacharya and Durney, 2001). A large international study finds that the level of enforcement is much more important than the quality of laws in the book in explaining the turnover of CEOs (Defond and Hung, 2003).

If the DFI approaching outside markets for finance faces a serious commitment problem, how can investors be assured that they will choose the right projects, exert sufficient effort, adequately disclose

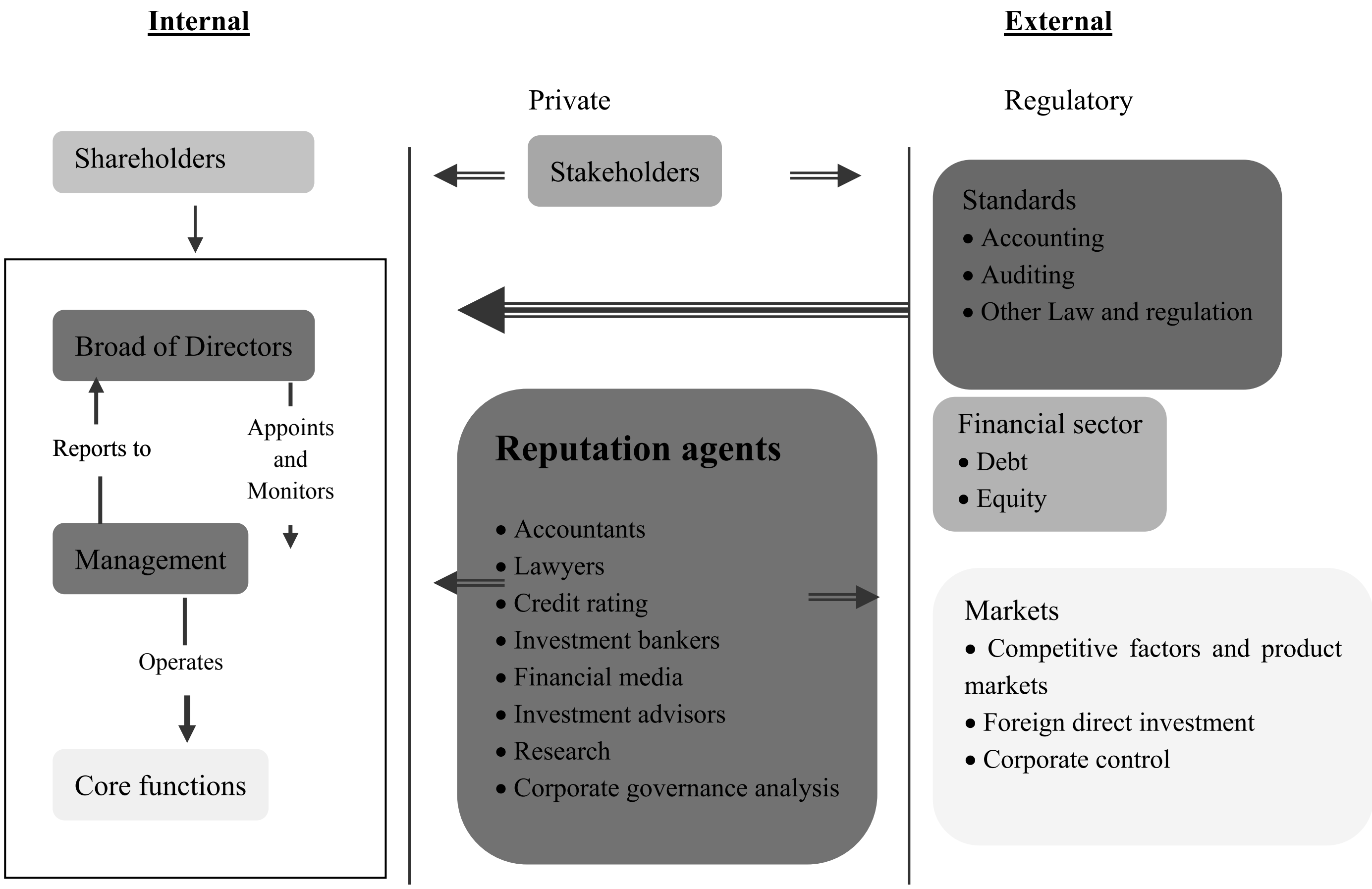
[4] See, King and Levine (1993a,b), Demirgüç-Kunt and Maksimovic (1998), Levine and Zervos (1998), Rajan and Zingales (1998), Beck, Levine, and Loayza (2000), Levine, Loayza, and Beck (2000), Wurgler (2000), Claessens and Laeven (2003), and reviews by Levine (1997, 2004).

relevant information, and ultimately repay investors? In the complete absence of credible commitment, outside investors will assume the worst-case scenario, i.e., that the DFI will use all opportunities to defraud investors or in other ways not live up to his promises. The worse is the DFI's commitment power, the costlier will its outside financing be (and the more difficult it is to recruit good personnel and establish long-term supplier/customer relationships).

Corporate governance is, in great part, about mitigating this commitment problem. We consider here definitions of corporate governance that are concerned with the normative framework, that is, the rules under which the DFI is operating, with the rules coming from such sources as the legal system, the judicial system, financial markets, and factor (labor) markets. We do not define corporate governance as a set of behavioral patterns, that is, the actual behavior of corporations, in terms of such measures as performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders.

Problems arise for two reasons: an individual investor may not have proper incentives to pay the costs involved in ensuring that the entrepreneur lives up to his promises and may attempt to free-ride on monitoring and enforcement by other investors; and the mechanisms to commit and punish may be missing or incomplete, possibly due to poor enforcement of property rights in the country. Typically the two problems will go together. When the costs of collecting information and enforcing contracts are high, investors will find it more difficult to monitor and will thus be less likely to do so when there are many investors; and the DFI cannot commit credibly as institutions are missing or mechanisms are too costly to make seeking external financing attractive. These problems involve costs, in a narrow sense of some transaction costs, and in a broad sense of lost firm and economic growth when some investment opportunities are not being financed.

Figure A: DFI is disciplined by internal and external factors



A corporate governance framework: the internal and external architecture

These two definitions from public and private perspectives provide a framework for corporate governance (shown in figure A) that reflects an interplay between internal incentives (which define the relationships among the key players in the corporation) and external forces (notably shareholders, policy, legal, regulatory, and market) that together govern the behavior and performance of the DFI.

The internal architecture defines the relationships among key players in the corporation

In its narrowest sense, corporate governance can be viewed as a set of arrangements internal to the corporation that defines the relationships between managers and shareholders. The shareholders may be public or private, concentrated or dispersed. These arrangements may be embedded in company law, securities law, listing requirements, and the like or negotiated among the key players in governing documents of the corporation, such as the corporate charter, by-laws, and shareholder agreements.

At the center of this system is the board of directors. Its overriding responsibility is to ensure the long-term viability of the firm and to provide oversight of management. The board is responsible for approving the company's strategy and major decisions and for hiring, monitoring, and replacing the management and has responsibility for ensuring compliance with laws and regulations, including accounting and financial reporting requirements. For a going concern, the board is answerable to shareholders and to employees and creditors. Its task is to protect the interests of the DFI. When the DFI runs into financial difficulty, the duty of board shifts to the DFI's creditors; the primary duty of the director is to the DFI rather than to shareholders. Since managers dominate, the key governance mechanism is the rules for selecting directors, who need to have enough independence to ensure that they will properly monitor managers' performance. The primary governance issue is how outside shareholders can prevent the controlling shareholders from extracting excess benefits through self-dealing or disregard the economic rights of minority shareholders. Common protections include limits on self-dealing by insiders, anti-dilution provisions, and appraisal or withdrawal rights for minority shareholders. Where a controlling shareholder dominates a publicly traded corporation, additional governance mechanisms may include voting rights, provision for outsider representation on the board, and takeover rules limiting the "control premium" that insiders can appropriate.

External rules provide a level playing field and keep players in line

These internal mechanisms for corporate governance are strengthened by external laws, rules, and institutions that provide a level, competitive playing field and discipline the behavior of insider whether managers or shareholders. In developed market economies these policies and institutions minimize the divergence between social and private returns and reduce costly agency problems, primarily through greater transparency, compliance mechanisms, and monitoring by regulatory and self-regulatory bodies. Notable among the institutions that discipline corporations are the legal frameworks for competition policy, the legal machinery for enforcing shareholders' rights, systems for accounting and auditing, a well-regulated financial system, the bankruptcy system, and the market for corporate control.

FIRMS ARE DISCIPLINED BY CONTESTIBLE MARKETS ... The broader business environment creates compelling incentives for insiders to enhance the value of the enterprise. Competition and trade policies that ensure contestable markets reduce rent-seeking behavior. Together with policies that encourage foreign direct investment, competitive markets force insiders to improve corporate performance or risk bankruptcy or takeover. The discipline from competition is likely to be felt earlier and more sharply if there is an effective market for corporate control.

Underperforming enterprises become targets for acquisition by firms or investors who believe that they can create more value by running the enterprise themselves. Insiders have a powerful motive to improve the company's performance in order to retain control. A control market may also redress some of the imbalance of power between insiders and outsiders. If the market is orderly and transparent, a contest for control often produces greater economic benefits for outside investors and creditors (at least in the short run) than if insiders had continued to operate an underperforming enterprise without challenge.

... A WELL-REGULATED BANKING SYSTEM THAT OPERATES AT ARM'S LENGTH FROM THE CORPORATE SECTOR ...Competition for credit can produce better insiders, as behavior as banks demand greater and more accurate information and better compliance with contracts. This ability to discipline insider behavior is greatly restricted, however, if the business environment has few creditor protections, weak contract enforcement, or unworkable bankruptcy laws. If the banking system and corporate sector are closely interlinked, corporate insiders may fail to share value with their creditors (and governments). If corporate insiders are, in addition, insiders of the banks, they may appropriate bank resources for their own purposes. It has become increasingly clear in recent years that for corporate governance to be effective, the banking system (both banks and their regulators) also needs good governance. This is especially important in many developing countries where banks provide most of the corporate financing. It means that an effective governance system must include consideration of the role and responsibility of all capital providers.

... AND TRANSPARENT, EMICIENT, AND LIQUID EQUITY AND BOND MARKETS…Efficient securities markets send price signals rapidly, rewarding or penalizing insiders through changes in the value of their interests in the company or in the company's access to capital. The system of rewards and penalties is severely diluted, however, if markets are not transparent, investments are costly to exit, or, in the case of institutional investors, if the investors themselves are poorly governed.

FIRM's PERFORMANCE IS MONITORED AND SPURRED BY REPUTATIONAL AGENTS AND ACTIVIST SHAREHOLDERS… Developed markets increasingly feature a dense network of reputational agents who significantly reduce monitoring costs. They include accounting and auditing professionals, lawyers, investment bankers and analysts, credit rating agencies, consumer activists, environmentalists, and the media. Keeping an eye on corporate performance and insider behavior, these reputational agents can exert pressure on companies to disclose relevant information, improve human capital, recognize the interests of outsiders, and otherwise behave as good corporate citizens. Some can also put pressure on government through their influence over public opinion.

Investors and activist shareholders have also championed governance reforms. Particularly in the United States but increasingly in other developed market economies, they have worked actively to ensure that managers and boards act in the interest of shareholders. Although these active institutional investors do not typically take a controlling ownership stake, their visibility and influence in capital markets give them a leverage that few corporations can afford to disregard. Venture capital firms too play a monitoring role in the governance of startup firms, particularly in knowledge-based industries. They have the expertise, resources, and responsibility to undertake intensive monitoring and overcome the information disadvantage that other investors may face.

Board functions

The main functions of a board are to...:

- Direct the DFI both as to strategy and structure.
- Establish from time to time a strategy for the company, including a determination of the businesses that the company should be in and those that it should not be in
- Ensure that the executive management implements the company's strategy as established from time to time.
- Ensure that the company has adequate systems of internal controls both operational and financial.
- Monitor the activities of the executive management.
- Select the chief executive, ensure succession and give guidance on the appointment of senior executives.
- Provide information on the activities of company to those entitled to it.
- Ensure that the company operates ethically.
- Provide for succession of senior management.
- Address the adequacy of retirement and health care benefits and funding.

Board composition

Most governance guidelines and codes of best practice address topics related to board composition including director qualifications and membership criteria, the director nomination process, and board independence and leadership.

Criteria

The quality, experience, and independence of a board's membership directly affect board performance. Board membership criteria are the described by various guidelines and codes with different levels of specificity, but tend to highlight issues such as experience, personal characteristics (including independence), core competencies and availability.

Director nomination

The process by which directors are nominated has gained attention in many guidelines and codes, which tend to emphasize a formal and transparent process for appointing new directors. The adoption of a formal procedure for appointments to the board, with a nomination committee making recommendations to the full board, should be recognized as good practice. It is generally agreed that the board as a whole has the ultimate responsibility nominating directors.

Mix of inside and outside or "independent"

Most governance guidelines and codes practices agree that some degree of director independence—or the ability to exercise objective judgment of management's performance—is important to a board's ability to exercise objective judgment concerning management performance. The majority of the board is to be comprised of independent directors. “The board shall include outside directors capable of performing their duties independently from management, controlling shareholders and the corporation”.

Nonetheless, a general consensus is developing throughout a number of countries that public company boards should include at least some non-executive members who lack significant family and business relationships with management. Definitions of "independence " vary. For example, according to the Brazilian Institute of Corporate Governance, a director is independent if he or she: has no link to the company besides board membership and share ownership and receives no compensation from the company other than director remuneration or shareholder dividends; has never been an employee of the company (or of an affiliate or subsidiary); provides no services or products to the company (and is not employed by a firm providing major services or products); and is not a close relative of any officer, manager or controlling shareholder.

Therefore, DFI should have independent directors, i.e., directors who are not officers of the institution; are neither related to its officers nor represent concentrated or family holdings of its shares; who, in the view of the DFI 's board of directors, represent the interests of public shareholders, and are free of any relationship that would interfere with the exercise of independent judgment.

Independent board leadership

Independent board leadership is thought by some to encourage the non-executive directors' ability to work together to provide true oversight of management. The purpose of creating an independent leader for the DFI is not to add another layer of power, but to ensure organization of, and accountability for, the thoughtful execution of certain critical independent functions—such as evaluating the CEO; chairing sessions of the non-executive directors; setting the board agenda; and leading the board in responding to crisis.

Disclosure issues

Disclosure is an issue that is highly regulated under securities laws of many nations. However, there is room for voluntary disclosure by companies beyond what is mandated by law. It generally agrees on the need for directors to disclose their own relevant interests and to disclose financial performance in an annual report to shareholders. Generally this is required by law, but even though directors are usually subject to legal requirements concerning the accuracy of disclosed information, they must also describe about the financial performance of the institution, as well as disclose information about agenda items, prior to the annual general meeting of shareholders.

Independent directors

Minimum attributes of an independent director:

* Should not be a former executive and must not have a professional relationship with the company (for example, represent the company's audit or law firm, or be one of the consultants).
* Should not be a significant customer or supplier.
* Should not be recommended or appointed on the basis of personal relationships.
* Should be selected by a formal board process.
* Should not be a close relative of any executive director.
* Should not hold a major share stake or represent any major shareholder.
* Should be an active participant on the board, not passive.

Professional capabilities of an independent director:
* Should know how to read financial statements and have some knowledge of various company laws, except for those who are invited to join the board as experts in other fields, such as science and technology, human resource development, the environment, or other areas germane to the company business.
* Should familiarize themselves with the operations of the company and the milieu in which it operates.
* Non-executive directors should meet the above-mentioned criteria for independence and should ideally account for no less than a third of the board for a publicly listed company.

The role of boards of directors

A universally accepted principle of corporate governance is that a board has a fiduciary role. Equally, directors must control the efforts of the board with due enterprise and integrity. As elected representatives of the shareholders, the board is expected to use its integrity and capability to vet corporate strategies, policies, plans, and major decisions, and to oversee and monitor management in the interests of the shareholders society. Therefore, the key to good governance of the DFI is an informed and well functioning board of directors.

However, there are far too many instances where corporate boards either have no professionally competent independent directors, or where executive directors form the overwhelming majority. The excuses are similar: either the independent director does not know the business, or there aren't enough people who fit the bill and have time to serve. Quite often, gray outsiders are appointed instead of truly independent directors.

The purpose of appointing non-executive directors is first to provide the board business with knowledge, objectivity, judgment and balance which may not be available if the board consists only of full time executives; and secondly to ensure that the performance of the executive directors and the management of the company are up to the standard required for the board of a publicly listed company.

Independent directors need to bring their expertise and knowledge to bear on the strategy and enterprise of the company. They must bring an independent judgment or issues of conformance and performance.

Board best practice

It is the duty of the board to meet often enough to set the business strategy of the company. Best practice suggests that:

* The board should meet no less than four times in any given financial or calendar year, with at least one meeting per quarter.
* Board members should set their agenda well in advance so that they have time to be conversant with the issues by timely dissemination of meeting papers and reports.
* Well-performing boards tend to have specialized committees on detailed monitoring, advisory, and oversight tasks, such as financial audit; remuneration of executives and senior managers; environmental, health, and safety compliance; and executive search. These committees should confer greater quality on the stewardship and fiduciary responsibilities of the board.
* Ensure that not only the board, but the company and its employees operate ethically.

Essential information for the board

The effectiveness of non-executive directors depends on the quality of information available to the board. In many countries companies have considerable expertise at hiding key information from non-executive directors. Agenda papers are either very thin or strategically voluminous, often arriving just a day or two before the board meeting. To ensure that "independent oversight" has meaning, certain key information must be placed before the board and form part of the agenda papers. Most international codes of corporate governance insist that the information to be supplied to the board must be sent reasonably in advance to allow non-executive directors sufficient time to review the issues contained in the agenda papers and, if necessary, to make their own independent inquiries. Very few, however, specify what constitutes "minimum" information.

Information for the board

* Annual operating plans and budgets, together with updated long term plans.
* Quarterly results for the company as a whole as well as business segments.
* Tax audit and internal audit reports.
* Default in payment of interest or nonpayment to any class of creditor.
* Major capital expenditure proposed.
* Any issue that involves possible public or product liability claims of a substantial nature.
* Any deviation from the agreed policy or strategy.
* Environmental, health and safety issues of significance in terms of cost and regulations.
* Disclosure of share dealings by directors in the company's shares.
* Disposal of investments that are of material nature.
* Details of joint venture agreements.
* Actual or potential labor and employee problems and their proposed solutions.
* Quarterly details of foreign exchange exposure, their tenure, the extent of exchange rate cover, and the steps taken to limit the risks of adverse exchange rate movement.
* Security analysts' comparisons of the company and others in the same industry.

Board-level committees

DFI should have at least four board level committees: executive, audit, remuneration, and nomination.

* *Executive Committee,* for day-to-day management supervision,
* The *audit committee* should consist of at least three members, the majority of whom must be independent, non-executive directors. It supervises a company's internal audit procedures and interacts with the external statutory auditor to ensure full financial compliance with the law and regulations governing accounting standards and financial reporting.
* The *remuneration committee* should also consist of at least three members, all of whom must be independent, non-executive directors. This committee should set compensation packages reflecting industry trends and the DFI financial state.
* The *nomination committee* should consist of at least three members, of whom the majority should be independent non-executive directors and conduct a systematic search for appropriately qualified, independent non-executive directors.

Review of CEO and senior management

Independent non-executive directors must review annually the performance of the DFI’s CEO and senior management. Whether this review is conducted by independent directors or by outside professionals should be left to the institution. However, the review has to be based on clearly defined objective criteria, whose norms the CEO and other executive directors should know well before the evaluation process starts. Moreover, there should be a clearly laid down procedure for communicating the board's review to the CEO and his team of executive directors. Managerial remuneration should be base on such reviews.

Directorial and board performance

The board of directors should periodically assess its performance as a collegial body as well as the performance of individual directors. Second, a committee of the board consisting of independent, non-executive directors should evaluate the performance of the DFI's CEO, other executive directors, as well as the role of the CEO.

Evaluating directors is important to the long-term success of corporate governance but is bound to have considerable disfavor because there are no clear-cut objective criteria for conducting such a review. There is, however, a bare minimum benchmark for underperforming non-executive directors: attendance at board and committee meetings.

There is a more uniform consensus about the board formally evaluating the performance of the other executive directors, and the senior management team that is one rung below board level. The most comprehensive statement on this is found in the recommendations in the1997 report of the U.S. Business Round Table: "The selection and evaluation of the chief executive officer and... the corporation's top management team is probably the most important function of the board ... The performance of the CEO, CEO should generally be reviewed at least annually, without the presence of the CEO or other inside directors" (Gregory and Forminard 1998, 66).

Attendance of directors

* The attendance record of directors coming up for reappointment should be made available to all shareholders.
* Corporate boards should not recommend the reappointment of non-executive directors who have not had time to attend (with leave of absence or otherwise) even 50 percent of board meetings and/or committee meetings.
* The nomination committee should not recommend directors who have had poor attendance records in their capacity as board members of other companies.

Credit granting standards need to be used in assessing the creditworthiness of borrowers. One of commonly used is the five Cs model:

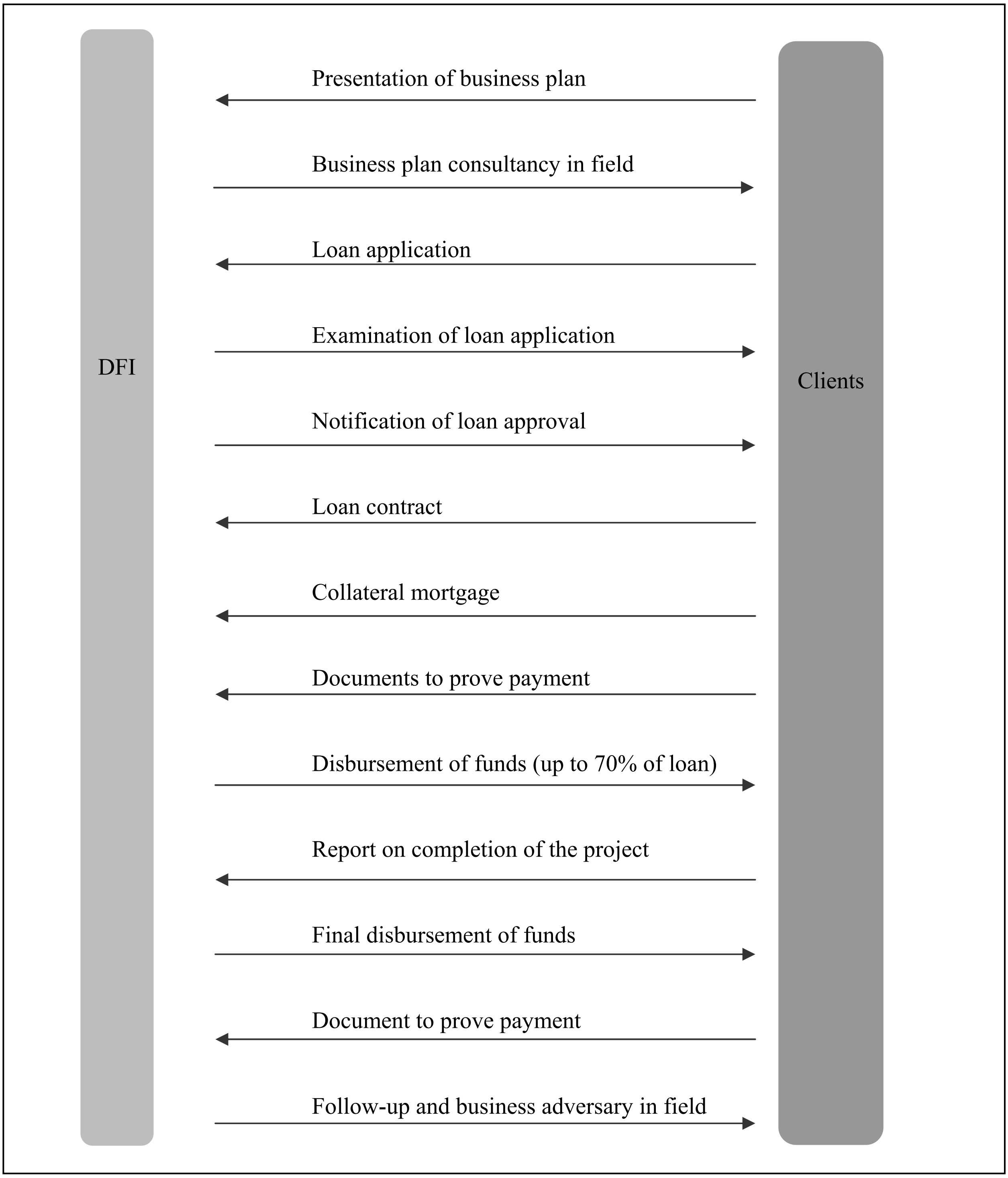
- Character: it must define what is considered acceptable business experience (for example, how many years in the business) and previous credit record;
- Capacity to repay: it must indicate what level of cash flow coverage is acceptable to the institution (that is the projected cash flow under various scenarios, divided by loan payments);
- Capital and financial resources: it must determine the minimum percentage of capital a prospective borrower must invest in a project, before the institution will consider lending (for example: an institution may require that the prospective borrower invest one penny into his or her project for each penny it can borrow).
- Collateral: It must describe what kind of assets are accepted collateral and how the advance value should be calculated (for example: loan value not to exceed 60 percent of collateral value);
- Clients and market: it must propose a simple method to assess market potential and competitive advantage.

Box A: Lending procedure

Loan procedure: At the initial stage, prior to submission of the loan application, an interview should be held and preliminary consultations and advisory services are needed. If the prospective applicant is judged to be bankable, then a request will be made for a submission of an application. Documents for submission usually include a loan application form, business plan, funding plan, repayment plan and other required documents.

Screening of application:

- Examining whether applicants and business plans meet the established policy objectives and compliance with national policies
- Conducting credit security that includes review of cash flow plan, funding plan, repayment plan, financial statement, and collateral and guarantors.
- On-site investigation, accounts payable ledgers, proof of payment of taxes are the necessary tasks.


DFI
Clients
Presentation of business plan
Business plan consultancy in field
Loan application
Examination of loan application
Notification of loan approval
Loan contract
Collateral mortgage
Documents to prove payment
Disbursement of funds (up to 70% of loan)
Report on completion of the project
Final disbursement of funds
Document to prove payment
Follow-up and business adversary in field

III. DEMAND SIDE ANALYSIS AS CORE FUNCTION OF DFI

1. Mobilization

Small and medium-sized enterprises play a vital role for Laos's economy and account for more than 60% of total business establishments. Broken down by sector, the majority of SMEs are in manufacturing furniture, wholesale and retail sales. Within the existing framework of financial system, commercial financial institutions which focus on relatively prominent SMEs, with allocations granted depending largely upon prevailing economic and financial conditions, have undertaken financing for SMEs. However, these lenders are not able to meet all the needs of SMEs, due to the high level of demand for financing. Moreover, customers are often not satisfied with the terms and conditions of loans extended by these organizations.

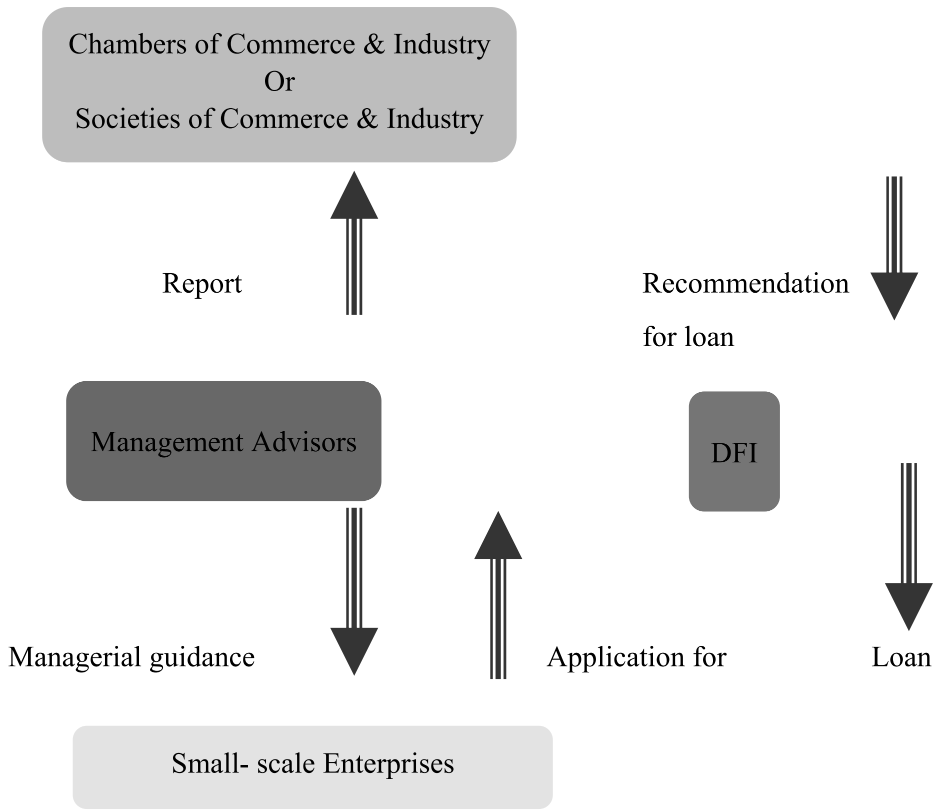
Therefore, one of functions of the DFI is probably to provide supplementary loans to this large segment of the economy. The DFI's goal is mainly to provide financing to SMEs that might otherwise not qualify for assistance from the commercial financial institutions. The mission of the DFI is not only to supply long-term loans, but also develop the business environment and quality by modernizing their operations and improving sanitation. The loan will help SMEs finance the restructuring and updating of their businesses in order to increase their competitiveness by introducing modernization of stores and improving sanitation standards; aiding business start-up specially for women and elderly entrepreneurs; improving management and distribution; and assisting in the acquisition of IT systems.

The managerial improvement loan is an important financial assistance for SMEs. In order to qualify for this loan, instead of having a guarantor or collateral, the formal recommendation of a local Chambers of Commerce and Industry or Societies of Commerce and Industry is needed. These are to assist those who find it difficult to designate a third-party guarantor or submit collateral for their loans. The other possibility for DFI is to introduce a loan service allowing a debtor to designate a family member or an employee as their guarantor.

Table 3

Type of loan	Purpose of loan	Terms & Conditions			
		Maximum amount	Period	Interest rate (per annum)	Remarks
Managerial Improvement Loans	To improve management of small scale enterprises	100 million kip(with extension loan 50 million kip)	Equipment fund: 7 years or less Working fund: 5 years or less	7%	Guarantor or collateral is not required

Loan Procedures



Loans not requiring a third party guarantor or collateral

Eligible applicants	Small businesses that satisfy all the following requirements: - A small business that has filed a tax return for more than one year. - A small business that has fully paid income and other taxes on time - A small business that is found to be eligible for loan without a third party guarantor or collateral, based on recent business records
Interest rate (per annum)	Standard rate + an additional (1%)

Loans for business start up not requiring guarantor or collateral

Eligible applicants	Those that meet any one of the following requirements: - An individual engaged in the business that they intend to start for five consecutive years or for a total of five years - An individual who has engaged for two or more consecutive years in a business that is related to techniques he/she mastered in a university course or similar institution, and intend to start a business closely related to that type of business - An individual who starts a business that will apply technologies or value added quality to assets and services of the business.
Requirements for self-financing	The applicant must cover half of the total start up costs.
Interest rate (per annum)	Standard rate + an additional (1.2%)

The agriculture, livestock and food industry (processing & distribution) are among the primary sectors for the country's social and economic development. Agricultural cooperatives play a central role in rural financing, however, in the financing investments in productive infrastructure, productivity improvement and in investments in improvements in the rural environment, it is usually supplemented by government program financing in form of loans through the Agriculture Promotion Bank (APB) or through an interest rate subsidy system, a feature that has become salient to this sector as described in section 2. However, the DFI would probably continue to enhance this system, due to fluctuations in productivity and prices, inherent low profitability due to the fragmented scale of the business, limited credit reliability, required long periods of gestation, and a low level of return on the investments, which are general characteristics of these sectors. Therefore, government program loans are extended for those projects that meet government policy objectives and such financing is considered to be important in carrying out the country's social and economic development.

The DFI will take one step forward to extend long-term and low interest rate loans, for example, through agriculture modernization loans to finance equipment and facilities, planting of fruit trees and flowers, acquisition of livestock; and through agriculture improvement loans to provide the new production technologies, to finance the construction of processing facilities, distribution facilities and wholesale markets.

The food-processing sector plays an important role in adding value to agricultural products and in supplying food that meets the changing needs for food consumption. In addition, the modernization of distribution systems is one of areas that the DFI cannot avoid.

2. Interest rate issue

In liberalized economies, the pricing of credit is usually determined as a function of three variables: ❶ an interest rate that the market will bear, that is an interest rate that the borrowers are willing to pay, and that an institute can charge to remain competitive; ❷ a rate that will generate enough income to cover funding costs, operating expenses and generate a profit; and ❸ a rate that will offer adequate compensation for the risk incurred.

However, a development financial institution has to price its loans according to the same principle and the pricing has to reflect some constraints specific to that type of activity:

- Whether the target clients are private enterprises or state-owned enterprises, pricing mechanisms and loan terms and conditions must be relatively clear and easy to communicate;
- Long-term loans tend to be riskier than other loans because they are usually made for big projects with a marginal profit, few types of collateral and future uncertainty of macroeconomic situation.
- A subsidized rate would probably be considered as a major problem, since the main sources of the imputed fund are from the budget.

The funding rate is determined according to the borrowing period, as described earlier. However, in consideration of the special nature of agriculture and livestock, which characterized by low profitability and a long gestation period before the benefits from investments begin to appear, loans for this sector need a fixed interest rate and will be set lower than for other types of loans. In addition, loans for SMEs, business start-ups and the processing and distribution sector will have interest rates that are set according to the loan maturity with a marginal profit.

• **<u>Currency issue</u>**

1. Inflation and exchange rates issue

The commercial banks' policy for management of its foreign exchange risk is to avoid any foreign exchange exposure. Most of state-owned banks accept US dollars and Thai Baht, but do not lend in these currencies. The foreign currency deposits they collect are either kept in cash or re-deposited abroad or at the local branches of foreign banks.

Many financial institutes are exposed to market risk in form of foreign exchange risk. This refers to the possible losses that an institution can incur if it runs open foreign exchange positions and the exchange rate moves against it. This may happen because of weaknesses in the local currency. However, for the DFI, currency should not be a problem because the main funds are supported in the form of local currency, beside the funds from foreign grants.

2. Borrowing in USD but lending in local currency and vice versa

Holding dollar deposits helps protect against devaluation of the local currency, but this protection is usually bought at a price, in the form of lower nominal interest rates. This can be in as much as the interest rate differentials will adjust to offset, at least partially, the expected rate of depreciation. But nominal devaluation of the local currency is not the only risk to be borne in mind. Real exchange rate fluctuations mean that holding dollar deposits is not in itself a risk-free strategy for a depositor whose consumption patterns include local as well as imported goods.

A shift by depositors in favor of dollars is unlikely to be associated with a corresponding one-for-one shift in the currency composition of the banks' lending. Faced with the need to hedge an increase in dollar deposits, banks can denominate more of their loans in dollars and/or reinvest some of the deposited dollars abroad. There is a limit to which the first route can be done safely: after all, dollar-denominated loans to local firms are an imperfect hedge for dollar liabilities, especially if the borrower has no foreign currency receivables (or more precisely unless the borrower stands otherwise to benefit from a nominal depreciation). Many banks have found, to their cost, that they have merely substituted credit risk for exchange rate risk.

The sizable risk of an open foreign exchange position and prudential limitations thus implies that, once the limit to safe and profitable FX lending at home has been reached, the remainder of the resources raised through dollar deposits at the bank will be placed into the international money market.

An obviously relevant consideration in this regard is how fast exchange rate changes pass through into local prices. If the pass-through is very fast, then local borrowers may be able to assume the exchange risk of a foreign-currency denominated loan, even if they have no foreign currency receivables.

Furthermore, banks typically have more market power in lending than in deposits. This also argues that the impact of changes in deposit dollarization on the share of dollars in bank lending could be limited. By the same token, an increase in the FX share of a constant total of deposits could result in a lower volume of lending overall.

If overall lending declines (for the reasons outlined above), this may be associated with higher bank lending spreads. More generally, availability of foreign currency resources can open profitable new lines of business and help enhance the profitability of loan markets by segmenting sub-markets.

REMARKS AND CONCLUSION

The government is committed to poverty reduction as the primary objective in Lao PDR's development policy. One of the main instruments stated in National Growth and Poverty Eradication Strategy (NGPES) focuses on private sector development and rural development. Achievement of these objectives is very important to extend the long-term financing of the private sector and rural development that the commercial banks cannot afford. However, intermediation of the government plays a vital role in this process in order to achieve these goals. At the early stage of country's development, since the financial system is not well developed and the funds are not much available to be mobilized efficiently, it is a necessary to find ways to develop the transforming process.

The possibility of establishing a development financial institution (DFI) is one of the instruments that will play a role as intermediation, but there are many factors that have to be taken into account in the existing of country's financial system. The review of the existing financial problems should be addressed, particularly, for the case of the Agricultural Promotion Bank, and drawing lessons from those issues, we have focused on three main issues: the availability of sources for funding, corporate governance, and the real mobilization of funds. The study has found some conclusion as followings:

- Policy based financing should be separate from commercial banks to provide medium- and long-term credit to viable enterprises in a prioritized area of development.
- For the sustainability of the new policy based financial institutions, if it is to be established, lessons learnt and conditions proposed in Chapter 2 should be applied, otherwise the new institution will repeat the same problems as of the past.
- The development financial institution is established by a law and is wholly state-owned because of its main function to implement government policy objectives.
- It may require national consensus and participation. The government has to entirely finance the funds supporting the capital of the DFI by injecting funds in subsequent fiscal years. The most important support of the government is the supply of funds including capital investment, government ongoing loans, and government guarantee on borrowing and bond issuance. Other forms of financial support include favorable tax treatment and exemption from central bank regulations. The DFI would receive interest-free government deposits during its rehabilitation period. Besides government funds, the DFI can develop with private sector capital participation, including foreign capital.
- The possible funds that the government would seek are the postal savings, the pension scheme fund, the insurance fund, and public bond issuance. In addition, the subsequent fiscal deficits have prompted the government to change its policies to reduce the capital investment and shift to private investment.
- There is no single agreed system of "good" governance. Each country has its own corporate culture, national personality and priorities. Efficient types may vary due to structural organization, managerial environment, market based strategies and the prevailing economic development stages.

- Improvements in enforcement are more often the result of bottom-up approaches, rather than top-down efforts. Capacity building is often important to support private initiatives (From rating agencies to banks) and will help build constituencies for reform. The role of competition is more generally to improve the environment for enforcement.
- The MOF would indirectly get involved. Policy is communicated mainly via the boards of directors; the intervention decision on individual loans is limited. Since the DFI would operate with a commercial bank status, it would probably be supervised and monitored by the Bank of Lao PDR. Roles and functions of the DFI should be well identified in order to avoid overlap with the tasks of commercial banks
- The social and economic plans have emphasized that the country should develop and modernize social and economic infrastructure in order to facilitate economic development in each region of the country and to accelerate the Lao's regional and international economic integration; to promote industries utilizing domestic natural resources, as well as actively promote small and medium-sized enterprises (SMEs) and handicrafts production; and to develop and promote all economic sectors, particularly the private sector, including foreign direct investment (FDI) in order to expand business opportunities, placing emphasis on export-oriented sectors that have a comparative advantage.
- Further study should be carried out on the real demand of credit. The study has to come to the conclusion as to what the costs and amount of real demand are; the exercise on statistical analysis would be important evidence to support the performance target of the DFI. In the additional exercise, a statistical study should be carried out on bond market issues and how to move forward to the stock exchange market.

6. Major Issues in Financial and Fiscal Sectors in Lao PDR

Masaaki KOMATSU

I. The Financial Sector

1. Banking Sector Problems: Background

The Lao economy has experienced periodic financial crises since 1990. In 1998 the banking sector experienced a serious crisis. To restore economic stability and financial soundness, the government introduced a bank restructuring program. Another banking sector crisis overwhelmed the economy in 2000, before the restructuring program was completed. Since then the banking sector has been in a de-facto default condition and not functioning. The repeated financial crises resulted in a loss of confidence in the Lao banking sector and its currency.

There are various causes for the crisis; however, the most important come from the fiscal sector. In 1998, a substantial amount of government deficits was financed directly by the central bank, which led to inflation of over 90 percent in 1998 and 128 percent in 1999 (see Table 1). Monetization of the fiscal deficits led to hyperinflation and the financial crisis. In 2000 another surge of fiscal deficit financing took place without any visible record. The government faced serious revenue constraints when grant assistance was declined. The first item to be cut was capital expenditures. The ratio of capital and on-lending expenditures to GDP declined from 15.5 percent in FY1997 to 12.6 in FY2000, and then to 10.1 percent in FY2001. This was an extremely serious development for the Lao economy, being in the early stages of development and having an immature infrastructure. Since the Lao government was under the IMF program, the government was not allowed to finance its deficits directly by the banking sector. Instead, the government requested the state-owned commercial banks (SOCBs) to extend credits to the private companies which undertake the construction of the government projects. Cosmetically there is no increase in government deficit; only the increase of bank credits to the private sector was recorded. Government payments to construction companies for infrastructure projects fell behind, since revenue shortfalls arose from structural, rather than seasonal, factors. Eventually these SOCB credits to private construction companies became non-performing loans (NPLs). Although these SOCB credits were recorded as claims on the private companies in the banks' balance sheets, the real borrower was the government. We call this "disguised fiscal deficit financing by the banking sector".

It is said that the total NPLs of the banking sector amount to much more than 50 percent of the loan assets (see Mr. Koyama's paper for details). Most of these NPLs are credits to the government and state-owned enterprises (SOEs). In order to rebuild a sound banking system and to restore the banking sector's financial intermediation, resolving the fiscal sector's problems is essential. Furthermore, the central bank must become independent from the government, and commercial banks must have the autonomy to make commercial judgments. Legal and institutional reforms should be discussed to ensure independence and autonomy in the banking sector.

2. Structure and Problems of the Commercial Banks

A brief summary of the consolidated commercial banks' balance sheets are shown in Table 2. We found the following unique structures and problems of the Lao commercial banks:

- The commercial banks keep high excess reserves throughout all periods. While the statutory reserve requirement is currently 12 percent, the commercial banks hold around 30 percent as reserves in a central bank account. This certainly reduces the banks' liquidity and profitability. It is not clear that the high reserves are deemed necessary because of (i) an illiquid and underdeveloped financial market or (ii) governmental guidance.
- Many transactions, including overseas trade, are settled on a cash basis because of Lao's underdeveloped financial markets and a lack of confidence in the banking system. Letters of credit (L/C) issued by the Lao SOCBs are not widely accepted in international financial markets. This may be one of the reasons why the Lao commercial banks maintain high Euro deposits in international bank accounts.

- Time deposits are a major entry on the liability side of the banks' balance sheet. Since the economy is heavily dollarized, more than three-quarters of deposits are denominated in US dollars and Thai bahts (see Table 3). The currency composition of loan assets is unclear, as there is no data available. There may be a serious currency mismatch in the banks' balance sheet.
- On the asset side, more than 50 percent of total deposits is held in the form of deposits in foreign bank accounts. In other words, the Lao banking sector leaks more than 50 percent of savings raised in the domestic economy (to be discussed in more detail below). Another 35 percent is held in the form of loans to the private sector. It should be noted, however, that a great deal of loans to the private sector are actually loaned to the government (in the form of "disguised fiscal deficit financings", as discussed). Around 15 percent of the deposits are direct claims on the government and SOEs.
- The basic function of the banking system is to absorb domestic resources in the form of deposits and to channel them to the ultimate borrowers (i.e., to the private sector). In 2003, the Lao commercial banks channeled 50 percent of total deposits to foreign bank accounts in the international financial market. This ratio was 54 percent in 2002, 39 in 2001, 56 in 2000, and 86 percent in 1999. An extremely large portion of domestic financial resources, mobilized in the domestic economic system, leaks to outside countries. It seems very strange that the Lao economy, with its extremely scarce financial resources, would be exporting capital overseas. It also means that the banking sector does not channel funds to the needed sectors in the domestic economy.
- Channeling funds to Euro bank accounts is safe and a sound investment for banks. There is a lack of sound investment opportunities in the domestic economy. Opportunities to lend to sound borrowers became limited with the high level of NPLs in the banking sector. Moreover, new rules under the IMF bank restructuring program prohibit new lending if the commercial bank has as NPLs more than 15

percent of its total loan assets. (Recently, all commercial banks have had much more than 15 percent NPLs.) Lao's banking sector capital exports are the result of the above economic conditions. Although capital exports appear strange and unproductive to its economy, such behavior is sound and rational from the bank's point of view.

- The Lao banking sector cannot and should not extend new loans to domestic borrowers under the current economic and financial conditions. Without lending opportunities, the banks have no incentive to mobilize deposits. The bank deposit rate is declining while the lending rate remains relatively high (see Table 1). As mentioned earlier, all these actions are a result of what the banks view as sound and rational behavior. However, this sound and rational bank behavior discourages domestic saving mobilization. Lower savings discourage investments and future economic growth.
- A bank restructuring program is currently in progress to restore the banking system with a relatively slow speed. Because of repeated banking sector problems in the past, international organizations are cautious about injecting capital, and attempt to make sure that each step of the program is implemented before they agree to invest (the so-called "carrot-and-stick" method). Even then, the capital investments and improvements in bank balance sheets would proceed only slowly. This restructuring program is expected to be complete after three years, which means the banking sector conditions described above (the capital export and financial disintermediation) may continue for the next few years.
- We are also concerned that the banks may face negative margins during the course of the restructuring program. As mentioned earlier, the banks keep large portion of their assets in the form of deposits at the Euro banks account, which can only produce very low returns. In addition, in during process of recapitalization, the banks hold more government bonds and less loan assets. The government would strongly prefer to maintain lower interest rates for government bonds since higher interest rates would increase the fiscal burden. Currently, the interest rates for government bonds are set at 1.5 percent p.a. for US dollar- and 11 percent p.a. for kip-denominated recapitalization bonds. These may result in a negative margin for commercial banks; if so, the bank restructuring program will not improve the banks' financial conditions.
- The NPL problem is not only for commercial banks but also for specialized banks, such as the Agricultural Promotion Bank (APB). APB has two types of credit, the first of which is directed lending based on government policies. Funding for directed lending is based on the two-step loans from multilateral agencies and the government budget. The terms and conditions of such credit are set by the government and the interest rate is much lower than that of commercial credit. Since this is directed government credit, APB's roles are limited. The second type of credit is loans based on APB's own resources, i.e., deposits. The interest rates on this type of the loan are higher than on the first one. It is important to note that the role of APB in credit decisions is much larger for the second type of loan compared to the first one. The NPL ratio of the first type of credit amounts to 50 to 60 percent of the total credit outstanding, while the NPL ratio for the second type is slightly above 10

percent (based on our interviews with APB staff and advisors in November 2003). This would be evidence that government-directed credit tend to result in a higher amount of non-performing loans. The APB plays a limited role in directed credit, thus APB staff scrutinize the credits with less caution. This is a typical case of “moral hazard”. Under such circumstances, APB staff would not have the incentive to improve their abilities and skills in analyzing and monitoring credit. It is clear from our interviews that the APB staff would not feel responsible for such directed credit. As a result, NPLs would increase—and their costs are borne by taxpayers.

3. Borrowers

We have relatively limited information on borrowers. We interviewed two state-owned companies and six private companies in November 2003, along with more private companies in the Pakse region. Our major findings are as follows:

- Most private companies, particularly the healthy ones, do not rely on borrowings from domestic banks. The major private companies appear to be cash rich and have bank accounts with overseas banks. For those companies that borrow, overseas costs are much lower compared to those of domestic banks; therefore, they tend to limit borrowings from domestic banks.
- Small and medium enterprises (SMEs) continue to rely on internal financing sources, i.e., from their own funds and/or their families.
- The main borrowers from SOCBs are the government and SOEs, both of which are causes for the banks’ NPLs.
- There are criticisms of the bank payment system. It seems the bank settlement system in Laos remains inefficient, so that many businessmen carry cash to the Thai border and settle payments through Thai banks.
- We did not hear strong complaints about the level of loan interest rates. The current banking sector problems seem to be at a more primitive stage, such as inefficient bank settlement systems and bank services.
- Monetization and bank access remains very limited outside Vientiane. Commercial banks do not have much interest or incentive to do business in rural areas, leading informal financial institutions to play important roles there. As we know, the lack of information and an underdeveloped legal system are the commercial banks’ major obstacles to doing business. However, the microfinance institutions may overcome these obstacles by relying on traditional information networks and social customs based on the family system.

4. Implications

- Most private companies, particularly healthy ones, do not rely on borrowings from domestic banks. Those who continue to seek financial resources from domestic banks are the public sector, i.e., the government and SOEs. These are some causes of today's NPL problems in the Lao banking sector. The development financial institution (DFI) proposed by our Lao counterpart should not be a vehicle for such financings.
- The public infrastructure should be financed by the government's budget. Only financially and commercially viable infrastructure projects can be financed by banking institutions; since the DFI is a financial institution, it should lend only to financially viable projects. The SOEs should be restructured first before being offered bank loans.
- Commercial banks currently have no incentive to mobilize domestic savings. Bank restructuring is essential for rebuilding the financial intermediation mechanism, thus the banking sector can channel funds to financially viable projects. Meanwhile, we should also seek possible sources and mechanisms to mobilize domestic savings.
- The root cause of the banking sector problems lies in the fiscal sector. The solution to these problems is to restructure the fiscal sector and to maintain fiscal disciplines. The central bank must have independence and commercial banks must be autonomous. Institutional as well as legal reforms should be discussed in this context.

II. The Fiscal Sector

1. Fiscal Sector Conditions and Characteristics

The government budget in Lao PDR is in a critical condition. The outstanding public debt has reached at 70 percent of its GDP. The overall central government budget deficit has been recorded at around 6 to 8 percent of the GDP in recent years. The ratio of debt services to revenue reaches close to 20 to 25 percent, putting a serious burden on fiscal expenditures, particularly on those for development. The large fiscal deficits and heavy debt burden are the most important factors hindering economic development in Laos.

A summary of central government budget statistics is shown in Table 4 and Table 5 (all figures are indicated in terms of percentage of the GDP). Our major findings are as follows:

- The central government's revenues and grants in terms of percentage of GDP have been declining since FY1999.
- Total revenues in FY2003 stand at 13.2 percent of the GDP, which consists of 9.6 percent tax revenue, 1.8 percent non-tax revenue, and 1.9 percent grants from overseas.
- Major sources of tax revenue are turnover tax (2.5 percent), excise tax (1.8 percent), and import duties (1.5 percent). Income tax contributes only a small share of 0.7 percent.
- As non-tax revenue, overflight revenues contribute the largest share, 0.7 percent in FY2003. SOE dividends contribute 0.3 percent.
- Grants from overseas sharply decline from 6 percent in 1998 to 2 percent in FY2002. This is the most

important factor in the sharp decline in total government revenue.

- As revenues decline, so do expenditures, but only slightly. In FY2003, the total expenditures (excluding capital cost for SCB) were 17.2 percent of the GDP, which consists of 8.4 percent current expenditures and 8.8 percent capital and on-lending expenditures.
- Although the ratio of capital expenditures to GDP is high, the capital and on-lending expenditures (in terms of GDP) have been declining sharply from 14.4 in FY1998 to 8.8 percent in FY2003. Overseas grants and ODA loans contribute around two-thirds of capital expenditures, thus a decline in ODA directly affects the level of development expenditures.
- The overall fiscal balance of the Lao government (excluding grants) remains at a deficit of 7.8 percent in FY2002 and 5.9 percent in FY2003. The overall balance including grants also remains at a deficit of 5.8 percent and 3.9 in respective years. On average, Lao's overall deficit (including grants) stands at around 4 to 6 percent of the GDP for recent years.
- The overall deficits of around 4 to 6 percent of GDP per year are financed by domestic and external sources. In recent years, almost all the deficits have been financed by external sources; in the past, however, a large portion was financed by the domestic banking sector, which led to a financial crisis. However, it bears reminding that "disguised deficit financings by the banking sector" still continued after 2000 (see section I).
- In FY2003, foreign financing amounted to 4.3 percent of the GDP, which consists of 6.2 percent project loans, 0.9 percent program loans, and 1.5 percent amortization. Fiscal expenditures, particularly capital expenditures, rely heavily on soft loans and grants.
- The majority of the government's debt is in the form of soft loans. The total external debt of the government, excluding those of public enterprise and borrowings from Russia, reached 66.8 percent of the GDP in FY2003. The total external debt, including public enterprise and Russian debt, reached around 90 percent in the same year. We understand that an agreement on debt reduction and consolidation was reached between the Lao and Russia governments in December 2003.
- Government debt, which mostly consists of soft loans, carries interest payments of 0.5 percent and amortization of 1.5 percent of the GDP. The soft loans' average terms and conditions are an interest rate of 1 to 2 percent per annum maturing in 30 to 40 years, with a grace period of 10 years (see the World Bank's "Global Development Finance 2001"). Because of soft loans, the debt service burden remains relatively low. However, debt services are expected to increase in the next few years since the grace period of those loans is coming to an end.

2. Framework of Fiscal Sustainability Analysis

The relationship between the government's debt and the fiscal deficit is described by the following equations (see Maxwell Fry, Chapter 2).

$$B_t = B_{t-1} + r \bullet B_{t-1} + X_t \qquad (1)$$

where B = government debt, r = interest rate, X = primary deficit, namely government expenditure (excluding interest paid) minus fiscal revenue, and t = time period.

Reformulating equation (1) to express debt in terms of the GDP ratio, the change over time of government debt is shown by the following:

$$db/dt = x + (r - g)\, b \qquad (2)$$

where b = ratio of government debt to GDP, x = ratio of primary deficit to GDP, and g = growth rate.

For the ratio of government debt to GDP to stay constant, db/dt should be zero. Therefore, for the condition to maintain a steady debt-to-GDP ratio, equation (2) is written as:

$$x = (g - r)\, b \qquad (3)$$

Equation (3) is the core of the analytical framework. It shows that when the interest rate for government debt (r) is higher than the GDP growth rate (g), the primary fiscal deficit (x) should be negative. In other words, the government should have a primary surplus in order to keep the ratio of government debt to GDP (b) constant. Otherwise, the ratio of government debt to GDP will continue to rise, leading to fiscal bankruptcy. It follows from the above that the basic policy needed to avoid such an adverse eventuality is to reduce government expenditures and increase tax revenues.

3. Analysis and Findings

The above framework appears too simple; real fiscal conditions are much more complicated. We certainly need to develop a more in-depth analysis based on detailed figures. However, this simple framework can tell us the basic mechanism of fiscal sustainability as well as important policy implications.

We use the FY2003 figures as a benchmark. Most of the figures used in this exercise are taken from the government's FY2003 budget figures, shown in Table 5, or are recent averages. First, we need to recapitulate key statistics. In 2003 Lao's ratio of total government debt to GDP (b) stands at 66.8 percent. Since we do not have a clear understanding of the legal status of Russian debt, we use the above government debt figures (which exclude SOEs' debt and Russian debt) in this analysis. For the moment we ignore domestic debt, which amounted to 1.4 percent of the GDP in FY2003. The average interest rate (r) on external debt ranges from 1 to 2 percent per annum. As a benchmark, we use an average interest rate of 1.5 percent. (We also calculated different scenario incorporating assumptions of high domestic debt and therefore higher real interest later.) According to the 2005 IMF Article IV Consultation report, the real GDP growth rates (g) are estimated at 5.3 percent in FY2003 and 5.8 percent in FY2002. As a benchmark, we assume an average GDP growth rate of 5.5 percent per annum.

Now we insert the above benchmark figures into equation (3). The primary deficit-to-GDP ratio (x), derived from equation (3), which maintains an unchanged ratio (x), is estimated at 2.67 percent

((0.055-0.015) × 0.668) based on the above assumptions. The actual ratio of primary deficit to GDP (x), which is equal to the overall balance (including grants) minus interest payments, was recorded as 2.9 percent (3.9-1.0) in FY2003, 5.2 percent (5.8-0.6) in FY2002, and 3.2 percent (4.0-0.8) in FY2001. This means that, during the recent year, the Lao government ran higher primary deficits than the steady state level. If this condition remains unchanged, the outstanding public debt to GDP ratio will continue to increase in the future, if the other conditions, e.g. the exchange rate, remain unchanged. (Note 1)

Our findings from the above calculation are the following:

- The Lao government can afford to run primary deficits of 2.67 percent of the GDP without increasing its current debt-to-GDP ratio.
- This is due to the extremely low ratio of interest costs to public debt, i.e., 1.5 percent per annum.
- Despite the extremely low level of interest costs, the actual primary deficit to GDP ratio is much higher than 2.67 percent. The estimate suggests that Lao's debt-to-GDP ratio will continue to increase over time if the above benchmark assumptions remain constant.
- The level of the Government debt is already high; the government should aim to reduce the government debt to GDP ratio rather than to increase it.
- We can also predict that the higher the real interest rate is than our assumption of 1.5 percent per annum, the lower the actual GDP growth rate is than our assumption of 5.5 percent, and the lower the level of grant aid is than the current 2 percent of the GDP, the more the estimated level of the steady state primary deficit will be substantially reduced. This means the Lao government can afford to run lower primary deficits in order to maintain a constant debt-to-GDP ratio.

Next we examine a hypothetical scenario in which the Lao government finances its deficits by issuing bonds in the domestic market. To visualize the impact of such financing, we simply assume all deficits are financed by issuing domestic government bonds denominated in kip. We also assume the interest rate carried by the government bond is in line with the current rate of treasury bills. The treasury bills are in short-term maturity up to one year and carry interest of over 20 percent per annum (see Table 1). If we assume a normal yield curve, the medium-term government bond with a maturity of 3 to 5 years would carry an interest rate higher than that of the short-term treasury bills. As a matter of simplicity, however, our assumption of a nominal interest rate on government bonds is the same as that of treasury bills, which is 20 percent per annum. With the current inflation ratio of 10 percent, the real interest rate is estimated to be 10 percent per annum. (One may say this is too optimistic, but this does not change our conclusion in any case.) We also assume other assumptions remain the same as in the benchmark scenario. Inserting the above assumptions into equation (3), we find that the ratio of steady state primary deficit to GDP (x) is estimated at minus 3.0 percent. This means the government must run a primary surplus of 3.0 percent in order to maintain the current government debt to GDP ratio (d), if all fiscal deficits are financed by domestic bonds. To run for a primary surplus in the medium term is not a realistic scenario for the Lao economy. It is clear from the calculation that government deficits financed by the domestic bond market would result in very serious pressures on the government budget and lead to a sharp increase in the government debt to GDP ratio and debt service burdens.

As a matter of balance, we should point out the benefits of financing government deficits with the domestic market. Those are (i) to avoid the risk of sudden changes in exchange rate depreciation; (ii) to have a better currency balance of government revenues and debt services; and (iii) to have a more stable source of financings by avoiding external shocks. There is no doubt that the Lao government should prepare for a developing domestic bond market, which requires much more time than one would expect. Eventually confidence would be restored and risk premium would be reduced, allowing a lower real interest rate to prevail.

Although the Lao government should prepare to develop the government bond market in the long term, under the current economic and financial market conditions, the government should only rely on domestic bond to finance its deficits in a limited extent. If government bonds should be issued, bond financing should replace external financing sources and not be used to finance additional government deficits. It is clear from the above discussions that the Lao government cannot afford to increase its deficit-to-GDP ratio; rather, the ratio should be decreased. Therefore the primary deficits must be kept below 2.67percent, i.e., its steady state level.

4. Key Factors Affecting Fiscal Sustainability

There is no doubt that economic growth is a necessary basis for restoring fiscal sustainability. From equation (3) in the previous section, we see that a higher growth rate than a real interest rate is the key to determining a permissible level of primary balance. The growth helps reduce the ratio of debt to GDP (d = debt/GDP) by increasing the denominator without reducing the nominal amount of government debt. Moreover, an increase in the GDP can provide a larger pool of resources to finance debt services and other government expenditures.

From the analytical framework above, it is clear that the Lao government must lower the fiscal deficit from its current level in order to maintain today's debt-to-GDP ratio, which is already too high. The Lao government must improve its fiscal management. There is no quick answer to this issue. It is essential to increase tax revenues by improving tax administration; revenue collection is below its potential. Comprehensive tax reforms may be necessary, including the introduction of a value-added tax. The income tax level can and should be improved substantially, although the low income levels and the high level of the subsistence agriculture sector limits its capacity. It is also necessary to improve capital expenditure efficiency. In the past, substantial portions of capital expenditures turned out to be inefficient and wasted.

Domestic interest rates affect the cost of interest payments. We expect government bonds will be issued to restructure and recapitalize commercial banks. High interest rates and interest burdens will seriously weaken the fiscal condition. It should be noted, however, that under such circumstances the government tends to exert pressures on the central bank to pursue a policy of low interest rates (the so-called "financial repression policy"). Artificially low interest rate policies would cause high inflation, eventually deteriorating both exchange rates and investors' confidence.

Managing exchange rates is essential for today's Lao economy. Depreciation of kip exchange rates would suddenly increase Lao's external debt in terms of kip and therefore its debt burdens. Moreover, depreciated exchange rates would hit the Lao economy, particularly those who receive incomes from chiefly domestic sources. A stable exchange rate is the key to maintaining low risk premiums and therefore low interest rates.

III. Summary and Conclusion

The major cause of the banking sector's NPLs can be found in the fiscal sector. The large fiscal deficits financed directly by the banking sector or indirectly in the form of "disguised financing by the banking sector" led to the substantial amount of NPLs in the banking sector. The banking sector's financing of government deficits also led to high inflation and thus to negative real interest rates, which brought about a loss of confidence in its currency and in the banking system. 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. Commercial banks must have strong incentive to mobilize domestic savings and to scrutinize its credits. When the banks follow their incentives, they also enhance domestic savings and improve sound banking practices (compatible with incentives). Currently the banks have no incentive to mobilize domestic savings and scrutinize credits (see Komatsu, M., 1998).

Current Lao fiscal situation is in critical condition. According to our estimates the level of the public debt to the GDP ratio, which is too high in terms of Lao's debt service capacity, would continue to increase over time. Eventually the debt-to-GDP ratio would increase and debt service burden surpass its capacity. In order to avoid such a dbt crisis to occur the Lao government must reduce its primary deficits by a few percentage points. Therefore the Lao government should also improve fiscal management. Government revenue collection is below its potential; a new VAT system should be introduced to widen its tax base. Government expenditures, particularly capital and on-lending expenditures, should be scrutinized more carefully, as in the past there were many unproductive expenditures including on-lending to inefficient SOEs and directed credits supported by government programs.

Given the low level of development and the high level of poverty, there is limited room for the Lao government to overcome economic difficulties by improving fiscal conditions. The Lao government alone may not be able to solve all the financial and fiscal sector problems, making the role of multilateral agencies and bilateral donors crucially important in the government's financings. Government fiscal and debt management requires close coordination with donors. Our policy dialogues should facilitate the prescription of constructive policy programs for rebuilding more resilient financial and fiscal sectors based on a better understanding and in-depth analysis of the Lao economy.

(Note 1) The actual figures, however, are not far greater than the estimated steady state primary deficits. Therefore, the increase in the actual ratio of government debt to GDP (d) has remained more or less constant in recent years. It should be noted that the actual ratio of debt level to GDP is affected by various other factors, including exchange rates and so on.

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Table 1: Laos Financial Indicators (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
M2/GDP	13.51	14.19	18.45	20.42	14.95	16.5	16.34	19.19	20.87
Currency/GDP	2.93	2.49	2.42	1.49	0.75	0.5	0.72	1.24	1.97
Money/GDP	4.73	4.38	3.63	3.99	2.12	2.52	2.37	3.19	4.12
Quasi-Money/GDP	8.82	9.81	14.81	16.44	12.83	13.98	13.97	16	16.75
Factor of Money Supply									
Foreign Assets		152.28	42.34	58.97	112.61	37.23	-40.21	95.48	56.74
Central Govt.		-84.73	-0.38	-1.79	-32.48	-20.72	97.46	-27.05	35.03
SOE		17.93	51.83	22.42	32.69	27.74	120.91	12.06	-29.21
Private Sector		51.94	80.64	53.76	49.98	48.68	92.82	-0.02	-4.64
Growth M2		26.73	65.76	113.28	78.36	46.04	13.72	37.6	20.07
Change Exchange Rate		14.5	36.8	161.78	115.32	11.06	13.53	12.3	5.1
Change CPI		13.02	27.51	90.98	128.42	25.09	7.81	10.63	15.49
Real Interest Rate		2.98	N/A	-73.19	-115	-13.09	-1.31	-4.63	-8.91
Treasury Bill Rate %	20.46	N/A	N/A	23.66	30	29.94	22.7	21.41	24.87
Deposit Rate	14	16	N/A	17.79	13.42	12	6.5	6	6.58
Lending Rate %	25.67	27	N/A	29.28	32	32	26.17	29.33	30.5
Margin	11.67	11	N/A	11.49	18.58	20	19.67	23.33	23.92

Source: IMF, International Financial Statistics Yearbook 2003, IMF, IFS July 2004

Table 2: Laos Central Bank Balance Sheet (billion kip)

Central Bank balance sheet, 1995

Foreign assets	85	Reserve money	84
Claims, govt. & SOE	11	of which outside DMB	42
Claims, private	10	Foreign liabilities	59
Claims, comm. banks	47	Govt. lending fund	16

Central Bank balance sheet, 2000

Foreign assets	1,147	Reserve money	767
Claims, govt. & SOE	505	of which outside DMB	68
Claims, private	143	Foreign liabilities	349
Claims, comm. banks	446	Govt. lending fund	211

Central Bank balance sheet, 2001

Foreign assets	1,266	Reserve money	822
Claims, govt. & SOE	673	of which outside DMB	113
Claims, private	151	Foreign liabilities	355
Claims, comm. banks	348	Govt. lending fund	347

Central bank balance sheet, 2002

Foreign assets	2,069	Reserve money	1,079
Claims, govt. & SOE	806	of which outside DMB	229
Claims, private	176	Foreign liabilities	461
Claims, comm. banks	218	Govt. lending fund	428

Central bank balance sheet, 2003

Foreign assets	2,227	Reserve money	1,330
Claims, govt. & SOE	758	of which outside DMB	399
Claims, private	153	Foreign liabilities	464
Claims, comm. banks	138	Govt. lending fund	324

Table 3: Foreign Currency Deposit and Credit from Monetary Survey (billion kip, end of period and %)

	2000	2001	2002	2003	Sept. 2004
Net foreign assets	1,528	1,485	2,326	2,724	3,115
BOL	799	915	1,612	1,797	1,981
Commercial banks	728	570	713	927	1,134
Net domestic assets	721	1,219	1,110	1,371	1,699
Credit to economy	1,859	2,553	2,638	2,454	2,678
of which forex	1,491	2,064	2,240	2,083	2,330
Forex credit %	80.20	80.85	84.91	84.88	87.01
Broad money	2,249	2,704	3,436	4,095	4,814
Narrow money	339	368	493	699	861
Currency outside bank	67	107	135	262	352
Demand deposits	272	261	358	437	509
Quasi-money	1,910	2,337	2,942	3,396	3,953
Time & saving	197	308	452	762	919
Foreign currency deposit	1,713	2,029	2,490	2,634	3,034
Forex deposit %	89.69	86.82	84.64	77.56	76.75

Source: IMF, Lao P.D.R. Selected Issues and Statistical Appendix, January 2005

Table 4: Central Government Budget (% of GDP)

	FY97 act.	FY98 act.	FY99 act.	FY00 act.	FY01 act.	FY02 est.	FY03 est.
Revenue & grants	15.1	16.6	16.9	16.3	14.5	13.2	13.2
Revenues	9.8	10.6	13.2	13.2	13.1	11.1	11.3
Tax	7.8	8.5	10.6	10.7	10.6	9.1	9.6
Nontax (overflight, SOE dividends, others)	2	2.1	2.5	2.4	2.5	2	1.8
Grants	5.3	6	3.7	3.1	1.3	2.1	1.9
Expenditure (excl. capital cost SCB)	23.6	20.6	21.5	20.7	18.4	19	17.2
Current	8.1	6.1	8.2	8.1	8.4	7.8	8.4
of which interest payments	1	0.7	0.8	0.9	0.8	0.6	1
External	-	-	0.7	0.8	0.6	0.5	0.7
Domestic	-	-	0.1	0.1	0.2	0.1	0.3
Capital & onlending	15.5	14.4	13.3	12.6	10.1	11.2	8.8
Current balance excl. grants	1.7	4.4	5	5.1	5.4	4.2	3.8
Overall balance	-8.5	-4	-4.6	-4.4	-4	-5.8	-3.9
Overall balance excl. grants	-13.8	-10	-8.3	-7.5	-5.5	-7.8	-5.9
Financing	8.5	4	4.6	4.4	4	6.4	4.4
Domestic financing	2.5	-0.6	-1.2	1.2	0.7	1.2	0.1
Bank financing	0.8	-0.4	-0.8	1.6	-1.3	0.2	0
Nonbank financing (asset sales, arrears, discrepancy)	1.7	-0.1	-0.3	-0.4	2.1	-0.1	-0.2
Foreign financing	6	4.6	5.7	3.2	3.3	5.2	4.3
Project loans	6.6	5.4	6.4	4.8	4.6	6.4	6.2
Program loans	0	0	0.7	0	0.3	0.8	0.9
Amortization	0.7	0.9	1.5	1.6	1.6	1.5	1.5

Memorandum items

Total public debt				66.5	71.2	68.1	66.8
External debt				65.5	69.4	66.7	65.3
Domestic debt				1	1.9	1.5	1.4
Nominal GDP FY (billion kip)	3,745	8,788	12,836	15,197	17,719	21,150	24,821
Actual program exchange rate			7,670	8,600	9,810	10,636	10,577

Source:
IMF, Lao People's Republic Third Review, Aug. 28, 2003
IMF, Lao People's Republic Staff Report 2002, July 12, 2002
IMF, Lao People's Republic: Selected Issues and Statistical Appendix, Jan. 2005
Note: (1) Financing items for FY01, FY02, and FY03 do not add up due to differing data sources.

Table 5: Central Government Revenues and Expenditures (% of GDP)

	FY 99/00	FY 00/01	FY 01/02	FY 02/03	FY 03/04
Revenues	13.2	13.2	13.1	11.1	11.3
Tax	10.6	10.7	10.6	9.1	9.6
Profit tax	1.5	1.4	1.4	1	1.1
Income tax	0.9	1	0.7	0.7	0.7
Turnover tax	2.3	2.1	2.1	2.2	2.5
Excise tax	1.8	2.4	1.6	1.4	1.8
Import duties	1	1.2	1.4	1.5	1.5
Timber royalties	2.1	1.2	2	1	0.7
Other	1.1	1.5	1.4	1.3	1.3
Non-tax	2.5	2.4	2.5	2	1.8
SOE dividends	0.3	0.4	0.5	0.4	0.3
Overflight revenues	1	0.8	1.1	0.8	0.7
Other	1.2	1.2	1	0.7	0.7
Expenditures	21.5	20.7	18.4	19	17.2
Current	8.2	8.1	8.4	7.8	8.4
Wages and salaries	2.6	2.7	3.1	3.2	3.5
Transfers	1	1.6	1.5	1.6	1.3
Interest payments	0.8	0.9	0.8	0.6	1
Domestic	0.1	0.1	0.2	0	0.3
External	0.7	0.8	0.6	0.5	0.7
Other current	1.9	2.9	3	2.4	2.6
Capital onlending	13.3	12.6	10.1	11.2	8.8
Domestically financed	3.7	5.7	5.6	4.9	3.4
Externally financed	10.1	7.9	5.3	7.1	5.9
Onlending (net)	-0.6	-1.1	-0.8	-0.7	-0.5
GDP (billion kip)	12,836	15,197	17,719	21,150	24,821

Source:
IMF, Lao People's Republic: Selected Issues and Statistical Appendix, Jan. '05
Note (1): There are some inconsistent figures between Tables 4 and 5.

Appendix Table 1: Laos Financial Indicators (%, billion kip)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Official Exchange Rate (period avg.)	804.69	921.02	1,259.98	3,298.33	7,102.02	7,887.64	8,954.58	10,056.3	10,569
Foreign Exchange Res. (million $)	78.01	159.19	99.62	106.13	101.12	138.87	127.51	185.51	189.46
Reserve Money	84.17	104.37	150.09	281.75	481.75	766.65	822.49	1,079.11	1,329.94
of which: Currency Outside DMBs	41.95	42.97	53.31	63.16	77.79	67.83	113.08	228.81	399.1
Monetary Survey (billion kip)									
Foreign Assets (net)	77.9	156.57	224.77	496	1,260.13	1,524.85	1,400.44	2,321.28	2,723.29
Domestic Credit	157.3	149.62	362.39	704.53	1,045.12	1,441.22	2,404.02	2,259.22	2,267.59
Claims on Central Govt. (net)	0.78	-43	-43.61	-51.84	-272.21	-419.56	-118.02	-378.92	-130.71
Claims on Nonfinancial Pub. Enterprises	27.67	36.93	120.42	223.55	445.39	642.63	1,016.73	1,133.04	926.1
Claims on Private Sector	128.86	155.69	285.58	532.82	871.94	1,218.14	1,505.31	1,505.1	1,472.2
Money	67.18	75.56	79.94	168.98	218.98	344.35	371.84	587	836.54
Quasi-Money	126.09	169.37	326.07	696.95	1,325.52	1,911.25	2,193.15	2,942.4	3,401.38
Other Items (net)	41.93	61.27	181.15	334.6	760.75	710.46	1,239.46	1,051.07	752.95
Money plus Quasi-Money	193.27	244.93	406	865.93	1,544.5	2,255.6	2,564.99	3,529.4	4,237.92
Consumer Prices	12.72	14.37	18.33	35	79.95	100	107.81	119.27	137.75
Gross Domestic Product (GDP billion kip)	1,430.36	1,725.7	2,201	4,240	10,329	13,669	15,702	18,390	20,307
M2/GDP	13.51	14.19	18.45	20.42	14.95	16.5	16.34	19.19	20.87
Currency/GDP	2.93	2.49	2.42	1.49	0.75	0.5	0.72	1.24	1.97
Quasi-Money/GDP	8.82	9.81	14.81	16.44	12.83	13.98	13.97	16	16.75
Factor of Money Supply									
Foreign Assets		152.28	42.34	58.97	112.61	37.23	-40.21	95.48	56.74
Central Govt.		-84.73	-0.38	-1.79	-32.48	-20.72	97.46	-27.05	35.03
SOE		17.93	51.83	22.42	32.69	27.74	120.91	12.06	-29.21
Private Sector		51.94	80.64	53.76	49.98	48.68	92.82	-0.02	-4.64
Growth M2		26.73	65.76	113.28	78.36	46.04	13.72	37.6	20.07
Change CPI		13.02	27.51	90.98	128.42	25.09	7.81	10.63	15.49
Real Interest Rate		2.98	N/A	-73.19	-115	-13.09	-1.31	-4.63	-8.91
Treasury Bill Rate %	20.46	N/A	N/A	23.66	30	29.94	22.7	21.41	24.87
Deposit Rate	14	16	N/A	17.79	13.42	12	6.5	6	6.58
Lending Rate %	25.67	27	N/A	29.28	32	32	26.17	29.33	30.5
Margin	11.67	11	N/A	11.49	18.58	20	19.67	23.33	23.92

Source: IMF, International Financial Statistics Yearbook 2003, IMF, IFS July 2004

Table 2: Laos Commercial Banks Balance Sheet (billion kip)

Commercial banks balance sheet, 1990 (billion kip)

Reserves	3		Demand deposits	6
Foreign assets	43		Time deposits, incl. forex	16
Claims, gov. & SOE	36		Foreign currency deposits	---
Claims, private	4		Foreign liabilities	18
Other	---		Credit from central bank	11
			Capital	6
			Other	---

Commercial banks balance sheet, 1995 (billion kip)

Reserves	44		Demand deposits	25
Foreign assets	91		Time deposits, incl. forex	126
Claims, gov. & SOE	40		Foreign currency deposits	---
Claims, private	118		Foreign liabilities	40
Other	---		Credit from central bank	42
			Capital	57
			Other	---

Commercial banks balance sheet, 1996 (billion kip)

Reserves	59		Demand deposits	33
Foreign assets	107		Time deposits, incl. forex	169
Claims, gov. & SOE	65		Foreign currency deposits	---
Claims, private	142		Foreign liabilities	47
Other	---		Credit from central bank	49
			Capital	67
			Other	---

Commercial banks balance sheet, 1997 (billion kip)

Reserves	78		Demand deposits	27
Foreign assets	180		Time deposits, incl. forex	326
Claims, gov. & SOE	102		Foreign currency deposits	---
Claims, private	247		Foreign liabilities	77
Other	---		Credit from central bank	51
			Capital	127
			Other	---

Commercial banks balance sheet, 1998 (billion kip)

Reserves	212		Demand deposits	106
Foreign assets	452		Time deposits, incl. forex	697
Claims, gov. & SOE	149		Foreign currency deposits	---
Claims, private	461		Foreign liabilities	169
Other	---		Credit from central bank	82
			Capital	216
			Other	---

Commercial banks balance sheet, 1999 (billion kip)

Reserves	403		Demand deposits	141
Foreign assets	1,143		Time deposits, incl. forex	1,326
Claims, gov. & SOE	233		Foreign currency deposits	---
Claims, private	729		Foreign liabilities	282
Other	---		Credit from central bank	314
			Capital	457
			Other	---

Table 2: Laos Commercial Banks Balance Sheet (billion kip)

Commercial banks balance sheet, 2000 (billion kip)

Reserves	689		Demand deposits	272
Foreign assets	1,076		Time deposits, incl. forex	1,911
Claims, gov. & SOE	304		Foreign currency deposits	---
Claims, private	1,075		Foreign liabilities	349
Other	---		Credit from central bank	490
			Capital	520
			Other	---

Commercial banks balance sheet, 2001 (billion kip)

Reserves	714		Demand deposits	256
Foreign assets	866		Time deposits, incl. forex	2,193
Claims, gov. & SOE	558		Foreign currency deposits	---
Claims, private	1,354		Foreign liabilities	376
Other	---		Credit from central bank	384
			Capital	574
			Other	---

Commercial banks balance sheet, 2002 (billion kip)

Reserves	939		Demand deposits	358
Foreign assets	1,577		Time deposits, incl. forex	2,942
Claims, gov. & SOE	636		Foreign currency deposits	---
Claims, private	1,329		Foreign liabilities	864
Other	---		Credit from central bank	252
			Capital	487
			Other	---

Commercial banks balance sheet, 2003 (billion kip)

Reserves	1,109		Demand deposits	437
Foreign assets	1,713		Time deposits, incl. forex	3,401
Claims, gov. & SOE	727		Foreign currency deposits	---
Claims, private	1,319		Foreign liabilities	752
Other	---		Credit from central bank	166
			Capital	201
			Other	---

Commercial banks balance sheet, Sept. 2004 (billion kip)

Reserves	1,187		Demand deposits	509
Foreign assets	2,120		Time deposits, incl. forex	3,953
Claims, gov. & SOE	799		Foreign currency deposits	---
Claims, private	1,527		Foreign liabilities	986
Other	---		Credit from central bank	103
			Capital	162
			Other	---

Source: IMF, IFS Yearbook 2003, IMF, IFS Feb. 2004

Microfinance

1. Saving Group and Credit Markets in Rural Laos

Akihiko OHNO
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Summary

In the villages of Laos various organizations are moving ahead with the shaping of microfinance. The biggest of these projects is the shaping of village saving groups by 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 out-reach 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, the FIAM saving groups provide out-reach type finance, and are dependent on internal funds (i.e., members' savings). This differs from the Grameen Bank in that in the future it can be expected that the savings of the rural villages will be mobilized.

In the present report, villages that have saving groups were selected in the special city of Vientiane and in Luang Namtha Province, followed by villages relatively more prosperous than these villages, and villages poorer than these; a total of six villages. An interview survey was then carried out on a total of 837 households in the villages. The following are the major results obtained.

1) The saving groups are rapidly increasing the amounts saved. 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 in the form of domestic animals or gold. Since savings that are a financial asset can be used to mobilize assets, this is effective in raising the economic welfare of the village.
2) The saving groups are an alternative to informal borrowing and lending. However, money-lending is not common; borrowing and lending between relatives is the main part of informal finance.
3) Even some land-owning households purchase rice prior to the rice harvest. For households like these, the saving groups make it possible to reduce seasonal poverty.
4) The saving groups also fulfill a role in the purchase of consumer durable goods and in the introduction of new farming techniques.
5) The monetary earnings of farmers vary, but the monetary income from farming itself is not large. If anything, the proportion of income from non-farm household income generating activities is larger. These typically are weaving, retail and trading, and the saving groups also fulfill the demand for capital for these activities.

Taken overall, the role played by the saving groups can be evaluated highly. However, a problem has

arisen in that the demand for loans is insufficient with respect to the satisfactory growth of savings. Already in a number of saving groups, the amount required for loans is less than the amount saved (in other words, the credit/deposit ration is under 1). 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.

1) The 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.
2) Consideration should be given to the use of the savings to build village infrastructure.
3) The saving groups are restricted to providing credit within the village. There is a need to consider making loans to saving groups in other villages where there is a shortfall of funds. This is a plan that CODI of Thailand is trying out in Laos. If it is successful, there is the possibility of village saving groups developing into regional banks. However, for that all kinds of legal preparations would be necessary. Further,
4) There is a need to look into the possibility of 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 form of industrialization and the improvement of infrastructure. In order to make this a reality, however, a reform of the present banking system, which is in a state of dysfunction, is essential. Without such reform there is the danger that this method will push the saving groups into decline.

1. Saving Group and Credit Markets in Rural Laos

1. Introduction

Credit constraints are often claimed as one of the major causes of poverty in rural areas in the developing countries since the villagers there are less entitled to access to financial services from formal institutions. Moreover, the financial market itself is thought to be underdeveloped in rural areas. In the 1960s massive financial infusions, often from the international aid agencies, began to be made in the rural economy, in the form of low-interest loans. This program was aimed to accelerate agricultural development, and targeted-finance to the poorer rural classes would rectify income inequalities.

Loans at lower rate of interest than a market-clearing rate would give rise to excess demand. Thus it is vital that the poor are targeted as borrowers. However the poor are scattered through the villages and the amounts they borrow are small. This would entail prohibitively high transaction costs (screening, monitoring and enforcement costs). Thus private banks face difficulties in engaging in targeting-the-poor loan activities marinating economic viability. That is why state-owned banks have embarked on the targeting-the-poor loans.

In actual fact, however, the targeting-the-poor loan policies all share the same assessment; 1) the below-market subsidized loans are often siphoned off by local elites and thus may nit reach the poor. This worsened income distribution: 2) the below-market loans underrated capital cost and made resource allocation inefficient: and 3) the availability of low-interest loans discouraged farmers' intention to save. [1]

Moreover, by emphasizing the distribution of aid funding from overseas, the financial institutions weakened the incentive to collect debts and deteriorated their economic viability. The result of this was that the farmers borrowing the money looked on the loans as a transfer of income, and repayment rates were constantly under 50%.

This is where small-scale financial services known as microfinance, represented by the Grameen Bank, makes an appearance as an alternative method. Five members from different households form a group, and if any one member of the group should be unable to make repayments, future loans to the other four members are suspended. This system of joint liability seems to have brought about a high level of repayment, with a non-repayment rate of no more than a few percent. However, the Grameen Bank is

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[1] Adams D.A. and D.H. Graham, "A Critique of Traditional Agricultural Credit Project and Policies", Journal of Development Economics, Vol.8, No.3, 1981, pp.347-366. Adams D.W. and R.C. Vogel, "Rural Financial Markets in Low-income Countries: Recent Controversies and Lessons", World Development, Vol. 14, No.4, 1986.

dependent on donor-financed subsidized credit, so that ultimately it is a system with a credit function but no savings function. So long as it does nothing to mobilize savings, it is doubtful that the Grameen Bank deserves to be called a bank at all, in view of the fact that from the point of view of economic development the mobilization of savings in the rural villages is an important policy concern.

It should be noted that micro-finance projects can be classified into two types: an out-reach type (the financial system approach) and a targeting-the-poor type (the poverty lending approach). The former emphasizes extensive out-reach of credit to borrowers for productive purposes. The latter concentrates on poverty eradication, and hence claims target-lending to the poorest of the poor. The Grameen Bank of Bangladesh is a leading example of the latter type. Target-lending to the extreme poor often involves credit subsidies, that is, crediting at below-market interest rates. But the literature on such donor- or government-subsidized services reveals that they often fail as mentioned above.[2] The village saving group we discussed in this paper falls into the concept of the financial system approach.

This paper will clarify the realities and problems of rural village finance, based on a rural household survey covering villages with and without a Village Saving Group. It has two main purposes; the first is to ask whether there exist savings surplus among Lao rural households, and if there exists, to clarify the saving pattern. The Village Saving Groups that have been so successful in Thailand and elsewhere are also being formed in the Lao PDR; the second purpose of this paper is to look at the influence the formation of these VSGs is having on the farmers' behavior, in particular on their saving habits. The experience of Thailand with regard to Village Saving Groups provides valid lessons for the Lao PDR. The Thai savings groups will be touched on in the Appendix.

This Report is set out as follows. Chapter 1 contains a description of the area and villages covered by the survey, and of the Village Saving Groups in the villages. In Chapter 2 We will give an outline of the saving and borrowing habits of the farmers. In Chapter 3 We will discuss the effect the introduction of the savings unions has had on the economic activities of the farmers. Finally, we will discuss the policy implications.

[2] Robinson S. Marguerite (2001) The Microfinance Revolution: Sustainable Finance for the Poor, World Bank.

2. Survey Area and Sample

2.1 Survey Villages

More than 30 NGOs and international organizations such as UNDP /UNCDF have launched various forms of rural micro-finance programs in the Lao PDR. Though some are reported to have ended in failure, the program Small Rural Development Project for Women initiated by FIAM (Foundation for Integrated Agricultural and Environmental Management) in cooperation with the Lao Women's Union, has seen great success.

The Project was started in 1997 to assist the establishment of village saving groups in 6 districts of Vientiane Municipality, Vientiane and Khammuane Province. Later, CODI (the Community Organizations Development Institute) of Thailand initiated a similar program in 3 districts of Vientiane Municipality. According to a report by CODI, as of December 2003, 149 saving groups had been formed under the FIAM project and 68 under the CODI project.[3] The saving groups are established in 31% of the 700 villages in the target area. The number of saving group members is 21,295 and total savings amount to 5,893,124,600 Kip (approximately 570 thousand US $). Average saving per member is thus approximately 277,000 Kip.

Vientiane Municipality and Luang Namtha Province located in Northern Lao PDR were selected as the survey areas. The former, where FIAM and CODI have implemented their programs, is involved to a significant degree in a cash economy in the Lao PDR, while in the latter the market economy is relatively less pervasive.

Table 2 Study Village

Vientaine Municipality		
Somsa Vanh	Saving Group	332
Hai	Relatively Rich	137
Sang Thong	Relatively Poor	122
Luang Namtah		
Lon	Saving Group	146
Thad	Relatively Rich	58
Pho Kham	Relatively Poor	42

Note: Sang Thong includes two villages of Ban Hin Lab and Ban Tha Na Hin, and Lon includes Ban Luang Pha Kham and Ban Chom Chen.

[3] A FIAM officer announced that the number reached 240 in August 2004.

We first selected one village with a saving group from each of the study areas. In Luang Namtha we selected the two adjoining villages of Ban Chom Chen and Ban Luang Pha Kham, which will be hereafter referred to together as Lon. Then, for reference purposes, two villages without a saving group were selected from each of the target areas respectively as control villages: one relatively richer and the other relatively poorer in comparison to the target village with a saving group (Table 1). A total of 837 households from 6 villages were surveyed in March and August 2004, using a structured questionnaire.[4] A random sampling method was not employed since a quasi-census survey of member households except for Ban Chom Chen was conducted. In addition, since more than 90 % of the households in the villages with a saving group have at least one saving group member, a comparison between member and non-member within the same village was not carried out. Non-members were reported at both extremes of income distribution.

2.2 Village Characteristics

The average farm size of the respondents (Table 2) is 8.15 rai (1.3 ha), and average paddy land is 5.89 rai (approximately 1 ha). The proportion of the landless is high in Ban Somsa Vanh, Ban Hai and Ban Chom Chen. Though most of the landless are traders and shopkeepers, in Ban Somsa Vanh there are 149 army households (HHs with at least one member working for the army) among the respondents (46.27%).[5] The proportion of landless is 43.9% for army households, and 23.4% for non-army households.

15.9% of the respondents (133) are identified as landless, and most of them (86.3%) purchase rice in the market.[6] In addition, 40.1% of farmers and 38.6% of rice producers, mostly marginal farmers and/or households with large families, purchase rice in the market (Table 3). Figure 1 shows the association between rice production and rice purchases. The data imply that the greater part of the respondents, mostly the poor and the landless, are subject to rice shortages especially when they are faced with an unexpected crisis.

[4] Questionnaires were checked for internal consistency by authors immediately after completion of an interview. When inconsistencies were found, an interviewer re-interviewed the informant about the item(s).

[5] Army households receive 24 kilograms of rice per army worker.

[6] The landless who do not purchase rice are army households.

Table 2. Land Holdings (rai)

	Operational Holding (A)	(A)>0	Operational Holding Paddy Land (B)	B>0	Proportion of Landless
Somsa Vanh	7.01 (8.60)	9.60 (8.23)	6.02 (7.91)	8.14 (8.21)	26.7
Hai	8.54(10.78)	10.17(11.06)	5.22 (7.50)	6.22 (7.80)	16.1
Sang Thong	8.61(7.38)	8.61(7.38)	5.45 (4.17)	5.45 (4.17)	4.9
Lon	6.08 (4.84)	7.00 (4.53)	4.58 (3.64)	7.00 (4.53)	13.0
Pho	11.94 (8.13)	11.94(8.13)	8.64 (6.03)	8.67 (6.02)	0.0
Thad	13.53 (24.91)	15.10 (25.87)	8.93 (17.79)	9.96 (18.51)	0.0
Total	8.13(10.48)	9.63(10.75)	5.89 (7.96)	7.00 (8.22)	15.9
N	837	706	837	706	133

Table 5 shows the sources of cash income. Since our major concern is the village financial market, we focused on cash flow and did not consider imputed income especially from agriculture. Thus the level of income in the table represents a combination of household wealth and the degree of involvement in the cash economy.

Table 3 Rice Purchasing by landowners and the landless

	Landless	Landowner	Total
Non Rice-buyer	18 (13.7)	423 (59.9)	441 (52.7)
Rice-buyer	113 (86.3)	283 (40.1)	396 (47.3)
Total	131(100.0)	709(100.0)	837(100.0)

Table 4 Rice Producers and Rice Buyers

	Non-producer	Producer	Total
Non Rice-buyer	23 (14.7)	418 (61.4)	441 (52.7)
Rice-buyer	113 (85.3)	263 (38.6)	396 (47.3)
Total	156(100.0)	681(100.0)	837(100.0)

Figure 1. Rice Production and Rice Purchase

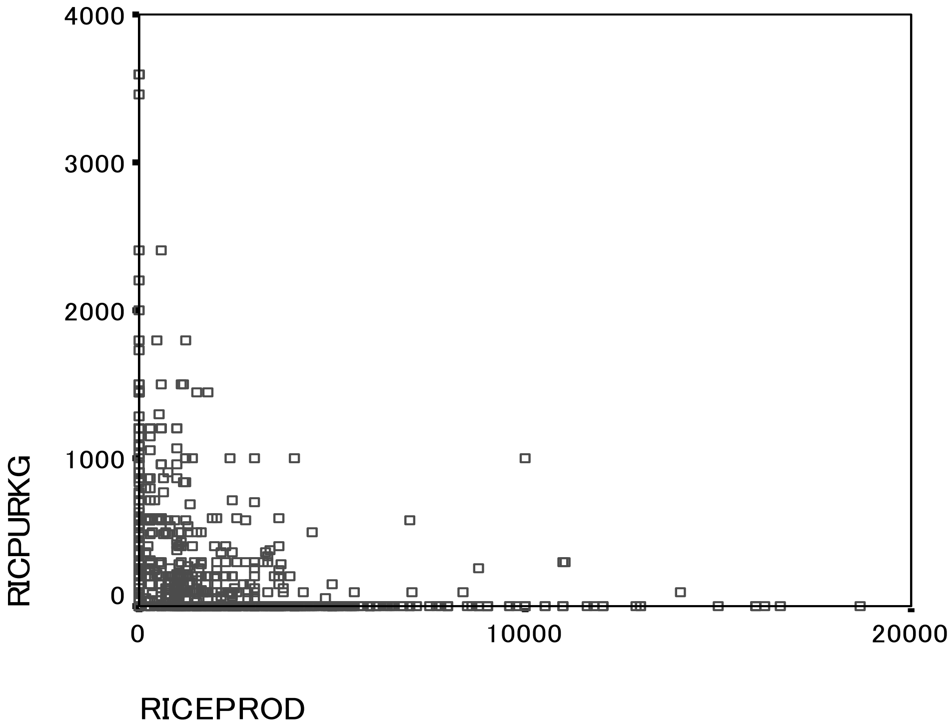


Table 5 (A) and (B) show income by source for landowners and landless respectively. Agricultural income in Vientiane Municipality comprises only a small portion of the total cash income, while income from self-employment occupies the largest portion of total income. Table 6 shows that the proportion of paddy rice sold to total paddy production is as low as 12.28%.

Table 5　Income by source (1000 Kip)

	Agriculture	Agricultural wage	Self-Employed	Salary	Remitance (Doemstic)	Remitance (Overseas)	Other Income	Total Income
Somsa Vanh	631	269	5,507	4,486	132	663	304	11,995
Hai	2,944	631	6,150	2,707	58	1,038	548	14,080
Sang Thong	1,599	916	2,187	723	90	818	249	6,585
Lon	1,797	279	3,397	2,385	32	46	941	8,880
Pho	2,077	172	441	839	40	155	80	3,807
Thad	6,394	106	291	526	30	93	0	7,441
Total	1,854	388	4,149	2,851	83	558	418	10,305

Note Income<15,000. N=804.

Table 5(A) Income by source, for Landowners

	Agriculture	Agricultural wage	Self-Employed	Salary	Remitance (Doemstic)	Remitance (Overseas)	Other Income	Total Income
Somsa Vanh	654	309	5,058	4,663	119	824	326	11,955
Hai	1,491	1,267	2,750	499	98	540	322	6,971
Sang Thong	2,031	307	3,227	2,188	37	52	1,010	8,856
Lon	2,077	172	441	839	40	155	80	3,807
Pho	6,394	106	291	526	30	93	0	7,441
Thad	1,848	366	3,401	2,817	79	461	431	9,406
Total	654	309	5,058	4,663	119	824	326	11,955

Table 5(B) Income by source, for the landless

	Agriculture	Agricultural wage	Self-Employed	Salary	Remitance (Doemstic)	Remitance (Overseas)	Other Income	Total Income	N
Somsa Vanh	567	160	6,746	3,996	167	221	244	12,105	85
Sang Thong	1,291	980	0	1,733	16	0	50	4,071	6
Lon	238	91	4,533	3,703	0	0	478	9,044	19
Total	550	193	5,996	3,822	130	171	274	11,138	110

Note: Those who reported positive agricultural income despite being landless are mostly army households receiving a rice allowance. There are also some rice-mill owners.

Table 6 Paddy Rice Sold as a Proportion of Production (%)

village	Mean	N
Somsa Vanh	8.76	260
Hai	19.05	85
Sang Thong	10.88	114
Lon	8.96	123
Pho	29.96	51
Thad	12.45	47
Total	12.28	680

Income from self-employed work constitutes the largest portion of cash income. As Table 7 indicates, 49.1% of the respondents are engaged in self-employed work, such as weaving (especially in Ban Somsa Vanh), trading and shop keeping. These occupations often require working capital, and thus village saving groups are expected to play an important role in the development of rural non-farmi household industries.

Table 7 Major Non-farming Self-employed Work (Respondents)

	Weaving	Sericulture	Shop	Trading	Others	Total	NFSE*
	185	1	20	27	20	253	
Somsa Vanh	73.1%	.4%	7.9%	10.7%	7.9%	100.0%	79.2%
	3	0	14	25	15	57	
Hai	5.3%	.0%	24.6%	43.9%	26.3%	100.0%	41.6%
	1	0	10	12	14	37	
Sang Thong	2.7%	.0%	27.0%	32.4%	37.8%	100.0%	30.3%
	1	0	12	28	6	47	
Lon	2.1%	.0%	25.5%	59.6%	12.8%	100.0%	32.9%
	0	0	1	4	4	9	
Pho	.0%	.0%	11.1%	44.4%	44.4%	100.0%	17.3%
	0	0	1	4	3	8	
Thad	.0%	.0%	12.5%	50.0%	37.5%	100.0%	13.8%
	190	1	58	100	62	411	
Total	46.2%	.2%	14.1%	24.3%	15.1%	100.0%	49.1%

Note: NFSE=proportion of the respondents engaging in non-farm self-employed work.

Livestock is considered an investment where people are not familiar with the banking system. Table 8 shows the average head of livestock owned in each village.

Table 8 Livestock

	Meat Cattle	Draft Cattle	Meat Buffalo	Draft Buffalo	Pigs	Goats	Ducks	Chickens
Somsa Vanh	2.44	.31	.12	.02	.20	6.11	13.71	.37
Hai	1.82	.18	.06	.02	.00	4.19	26.20	.02
Sang Thong	1.23	.08	.59	.33	.80	5.86	16.98	.59
Chom Cheing	.67	.16	.50	.79	1.25	4.38	12.16	.07
Pho	1.02	.44	.60	.73	1.21	3.50	12.96	.00
Thad	.36	.38	.03	.09	.05	5.97	15.64	.26
Total	1.62	.24	.27	.25	.49	5.28	16.05	.26

2.3 Somsa Vanh Saving Group

Ban Somsa Vanh is located in the Xaythany district of Vientiane Municipality, approximately 27 km from the center of Vientiane city south on Route 13. The village started a saving group on October 9, 1998 and was one of the first target villages of FIAM. In the village, water for agriculture is scarce and before the introduction of the saving group there was only one well for drinking water; a community well on the premises of the local temple.[7] The saving group is now ranked second in terms of per capita saving and first in terms of membership size (Table 9). We selected Ban Somsa Vanh as a study village so as to obtain a sufficient sample size from one saving group.

Table 9 FIAM Saving Group Villages established in 1998

	Year of Establishment	Members	Total Savings	Per Capita Savings
Somsa Vanh	9Oct98	604	358,872,100	594,159
A	7Sep98	124	32,360,500	260,971
B	9Oct98	68	27,209,000	40,013
C	25Aug98	261	147,000,000	563,218
D	21Sep98	96	19052000	198,458
E	24Sep98	67	18,000,000	268,656
F	16Sep98	78	15,167,000	194,448
G	1Mar98	149	116,047,000	778,729
H	30Apr98	111	57,314,000	516,342
I	5May98	235	105,760,000	450,042
J	9May98	72	15,277,500	212,186
K	10May98	41	7,670,000	187,073
L	14Sep98	100	41,884,000	41,884
M	25Sep98	43	8,468,000	196,930
N	1Oct98	76	17,273,000	227,276
O	10Oct98	35	3,262,000	93,200
P	10Oct98	150	48,560,000	323,733
Q	15Oct98	97	5,746,000	59,237

Source: CODI Report (in Lao), 2004.

Note: Data of member households are not available. Village saving account books do not give household data either. This is because the number of members is more critical for the group than the number of households.

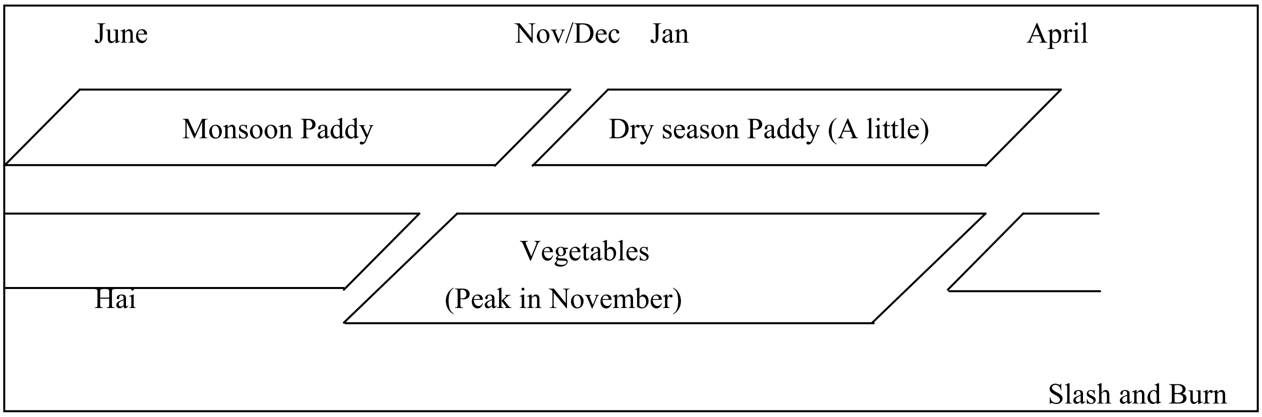
Basic information on Ban Somsa Vanh is presented in Table 10. The agricultural calendar of the village is shown in Figure 1. June (rice transplanting) is the agricultural peak season. Power tillers have been in use since around 1985, and bullock ploughing is falling into disuse. There are 20 power tillers which are leased out at 60,000 Kip per rai (tilling two times). The agricultural wage rate for rice transplanting is 20,000 Kip a day. In addition, chemical fertilizer needs to be applied to the paddy. Thus, June turns out to be a peak season in terms of capital requirement.

[7] The groundwater level is as deep as 50-60 meters, since the village is located on a hill.

Table 10 Basic Information for Ban Somsa Vanh

Area 3,513,047 m^2		
Paddy	2,174,164 m^2	(61.89%)
Garden	860,256 m^2	(24.49%)
Hai(slash and burn)	52,893 m^2	(1.51%)
House	425,734 m^2	(12.11%)
Population	2,335 (Female 1185)	
Households	425	
Families	430	

Figure 2 Agricultural Calendar in Ban Somsa Vanh



In 1998 FIAM visited the village to explain about saving groups to the villagers. Though many villagers attended the meeting, the majority returned home immediately after they were informed that FIAM did not provide any seed money. On the second meeting with FIAM on October 9, 1998 a saving group was set up with 89 members. This number increased to 364 in January 2002, 452 in January 2003, 612 in January 2004 and was 632 in March 2004, at the time of the survey. Approximately 90% of households have at least one saving group member.

At the initial stage, members were taught about the concept of saving and requested to save 100 Kip per day in order to be able to deposit 3,000 Kip per month. Later the minimum deposit was increased to 5,000 Kip per month. Most of the loans are short term loans: 3 months for working capital for handicraft and household expenses, and 6 months for paddy cultivation, livestock investment, education and house building. The interest rates are 3 % per month for ordinary loans and 2 % for emergency loans. A ceiling on credit is set at up to 5 times the amount deposited in the saving account, and credit requires collateral, such as land, a TV set, etc.

The group has the following internal regulations, decided on by members with reference to sample regulations provided by FIAM.

1) A member of the saving group shall be a village resident and registered in Ban Somsa Vanh.
2) No discrimination with respect to age or social class.
3) Loans are provided only to women who have a job or a family.
4) Members should deposit at least 5,000 Kip a month.
5) Saving deposits and withdrawals, and payment of monthly interest are made on the 15th of each month.
6) Members who miss the due date for one month will be cautioned, and those who fail to save for two months in a row will be dismissed from the saving group.
7) Applicants for membership should pay a fee of 3,000 Kip.
8) After depositing three months in a row, a new member becomes eligible for a loan.
9) Members can borrow up to 5 times their savings.
10) All members can borrow money from the group.
11) The term of a loan is 4 or 6 months.
12) A member who withdraws savings mid-term will forfeit the right to the annual saving interest dividend.
13) Interest rates

Emergency loan	2 %/month
Trading loan	5 %/month
Others	3 %/month

14) Distribution of net profits

Group Committee	15%
Members	70%
Social Development	5%
Advisory Committee	2%
Reserve Fund	8%

The group has account books; saving account, loan account and balance sheet books. The loan account book indicates no loans made at 5 % interest rate. Though the interest rate is high at 3 % per month, members can receive dividends that amount to 70 % of net profits, most of which is income from interest. Thus, the overall interest rate works out at 0.9 % per month, which is far below the loan rate of formal banks (nearly 30 % per annum).

Figures 3 to 5 show the growth of the saving group. Loan disbursement drops in the months before September when accounts are closed. Thus, loan repayment reaches a peak in September. Though the demand for loans has exceeded the amount of saving, in March 2003 for the first time demand was less than the amount of savings. The saving group then decided to lend some funds to the saving group of another village. The amount saved has grown steadily, but it seems to be getting difficult to find profitable economic opportunities.

This has not happened in the saving groups in Thailand surveyed by the author (Appendix). This seems to be partly because rural household non-farm income generating activities are prosperous businesses.

Figure 3 Changes in Monthly Saving in Ban Somsa Vanh

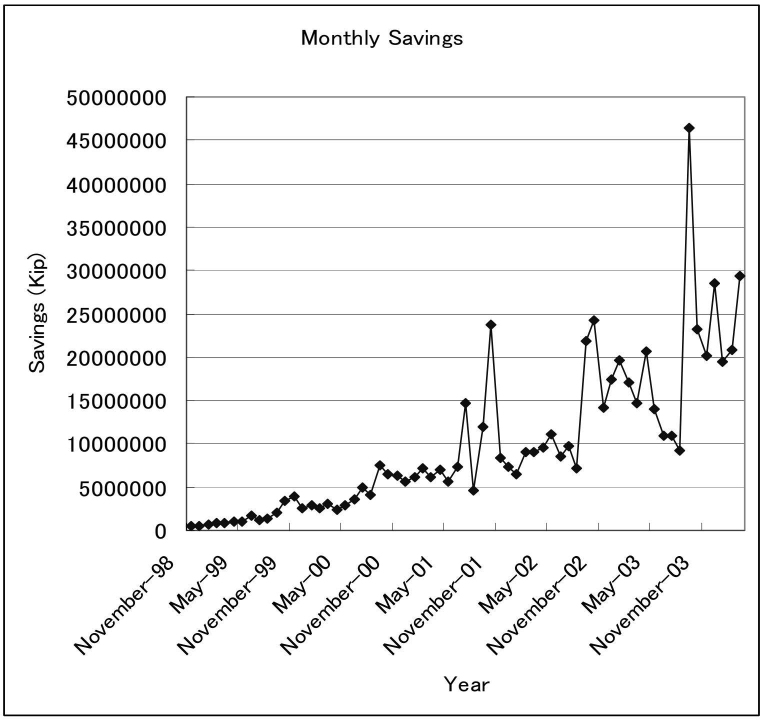


Figure 4　Changes in Monthly Repayments in Ban Somsa Vanh

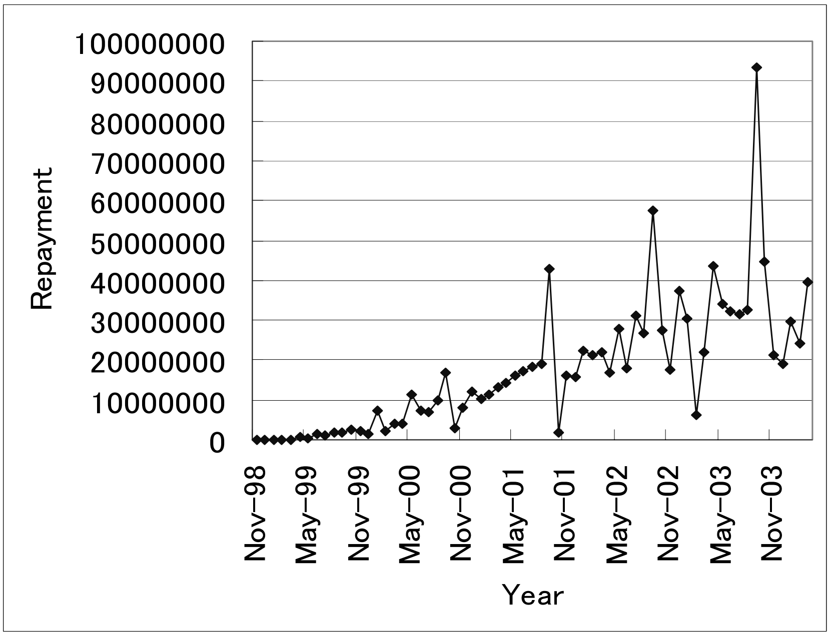
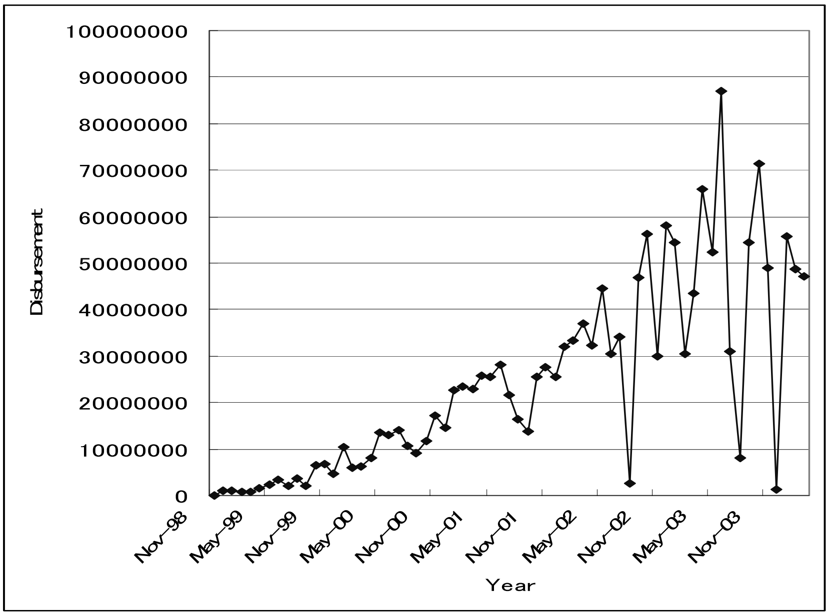


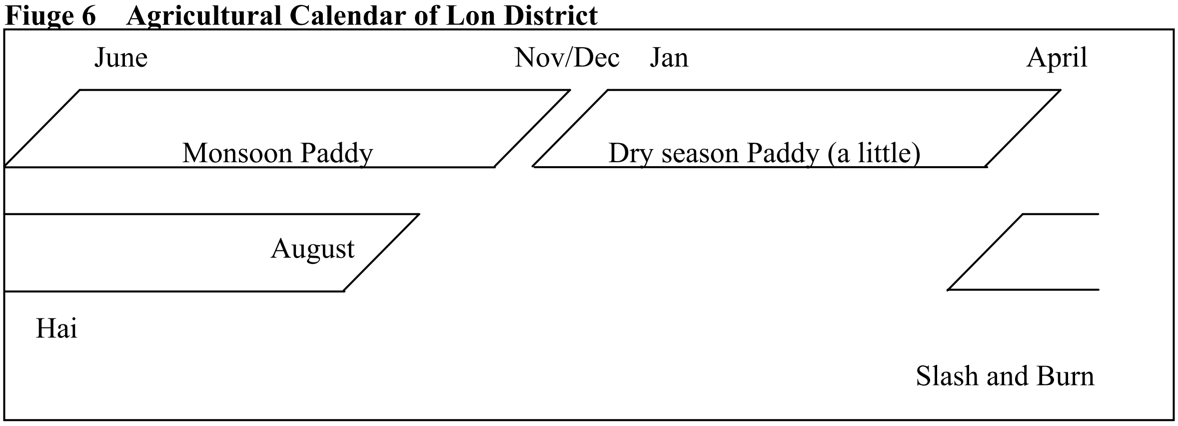
Figure 5 Changes in Monthly Disbursement in Ban Somsa Vanh



2.4 Lon Saving Group

The Lon District of Luang Namtha Province where FIAM-affiliated village saving groups have been established in recent years was selected as a study area. There are 93 villages in the district with a total population of 27,864 (female: 13,094). Chom Chen is the district center, but it has a population of only 1,465 in 293 households.

Fiuge 6 Agricultural Calendar of Lon District



Note: Dry season paddy is cultivated near the river bed.

The district is located about 47 kilometers to the west of Muang Sing. Thirteen kilometers further on lies Xieng Kok, a town on the Mekong. In1997/98 the road from Muang Sing to Xieng Kok was developed for motor traffic, from which time a monetary economy gradually started to spread in the area.

A major crop in the area is monsoon paddy. A high-yielding variety was introduced from China (Co Dio) in 2001 that yields 6-8 tones per ha, in contrast to traditional varieties yielding 4.5 tones per ha. No chemical fertilizer is applied to either.[8] At the time of rice transplanting, it is a common practice to hire wage labor: 50 persons for 4.5 hours per ha with a wage rate of 8,000 Kip per person. Rice transplanting after the monsoon has started is an urgent task, and hence the hiring of labor is more common than labor exchange. This entails a large demand for cash (Table 12).

The district forms a part of the so-called 'golden triangle'. Norwegian Church Aid (NCA), that has struggled against opium production, started microfinance programs in 2002 with the assistance of FIAM, so as to support income-generating activities in the area. As of June 2004, 9 village saving groups were in operation. 718 members in total save 12,118.1 thousand Kip (approximately 12 thousand US dollars). Of the 9 saving groups, we selected two adjoining villages, Ban Chom Chen and Ban Luang Pha Kham, as study villages; and these will hereafter be referred to as Lon. [9]

[8] HYV seed costs 27,000 Kip per kg. 10 to 15 kilograms of seeds are necessary per ha. HYV needs to be planted on fertile land. Otherwise its yield remains around 3 tones per ha. It is expected fertility would decline after a few years and then chemical fertilizer would become necessary.

[9] As the saving villages in Lon District consist of ethnic minorities (the dominant ethnic group is the Akha) with whom our interviewers have difficulty communicating. The villages selected are Tai Lue villages, where our interviewers shared a language with the villagers.

A saving group was established in June 2002 in Ban Luang Pha Kham and in June 2003 in Ban Chom Chen, with the assistance of NAC and FIAM. Thus they have regulations similar to those of the Somsa Vanh saving group. There are 59 households with 294 residents in Ban Luang Pha Kham. Its saving group has 84 members and all but one household has at least one member. Ban Chom Chen has 293 households, of which 104 have at least one member.

Table 11 Saving Groups in Lon District as of June 2004 (000 Kip)

	Members	Savings	Interest Income	Total
Luang Pha Kham	94	18,621	689.5	3,830.7
Huakua	99	1,004.5	3,110.5	13,602.5
Pakha	61	5,350.5	369	6,037.5
Chom Chen	228	42,624	6,431.5	50,498.5
Tao Hom	49	739	123	1,037.5
Dong Yong	68	4,491.5	950	6,094.5
Houi Tou Mai	45	279	31.5	1,651.5
Cha Mai	47	1,163	108	2,099
Pha Ngam	27	1,159	0	12,535
	718	8,447.2	18,018.5	121,181.5

Source: Lao Women's Union Office in Lon District

The term of a loan is 12 months in Ban Luang Pha Kham and 6 months in Ban Chom Chen. Since the latter saving group started only recently, the total amount of savings is one-sixth that of Ban Luang Pha Kham. This makes the term of a loan shorter. The committee members intend to extend loans up to 12 months once there are sufficient funds. Loan interest is 3 % per month for ordinary loans and 2 % for emergency loans. The interest rate for a trade loan is 4%, and the term is 3 to 6 months.

There is no ceiling on credit. Since demand for loans is far larger than the total savings, loan size per borrower cannot be large. However, since the size of the loan exceeds the amount of the borrower's savings in the account, collateral is required in addition to having two members stand as guarantors.

Table 12 Monthly Disbursement of Loans ('000 Kip)

	Amount of Loans			
	Luang Pha Kham	No of Borrowers	Chom Cheng	No of Borrowers
2003 June	12,700	16	3,000	7(5)
July	1,500	10	3,660	15(15)
August	600	7	3,220	12(1)
September	900	6	6,900	18(4)
October	2,200	11	7,750	16(5)
November	0*	0	6,570	9(5)
December	18,550	29	13,313.5	14(4)
2004 Jan	5,250	7	6,180.5	9(3)
February	1,700	2	7,625	7(0)
March	150	1	7,910	13(1)
April	350	2	5,402.5	3(0)
May	1,000	1	40,099**	36(12)
June	3,790**	40	1,029.2	14(9)
July	1,200	4	8,460.5	10(3)
August	500	1	15,880	***12(0)

Source: Account books of saving groups

Figures in parentheses show borrowing for agricultural purposes.

* Not operated because of rice harvesting. Borrowers tend to repay the loans after selling the harvested rice, so that many people are able to borrow due to the expanded funds.

** Month accounts are closed: June in Luang Pha Kham and March in Chom Chen. Since all loans need to be cleared off in the closing month, few borrow in the preceding month(s). For example, in May only one trader took out a loan in Ban Luang Pha Kham. Conversely, due to the expanded funds and the high demand for credit for rice transplanting, many loans are taken out in the closing month.

*** From August to October the main reason for borrowing is to purchase rice for consumption.

3. Savings and loans

In this section, we intend to draw a comprehensive picture of the overall situation regarding savings and loans in our study site. We will focus on the following key questions:

- How many households are saving, and how many are borrowing?
- How are they saving?
- Who are they borrowing from?
- What are the loans used for?

3.1 Savings and loans

The overview of saving and loans in the study area is summarized in Tables 13 and 14, respectively. The former shows the amount of savings made in the previous year, while the latter shows; (i) the percentage of households that had borrowed at least once in the past three years, and (ii) the average total amount of loan per resident household. Households in the village are divided into two subgroups according to the status of paddy holdings (non-farmer: without paddy, farmer: with paddy).

Table 13: Savings (1,000 Kip)

		Bank	SG	Gold	Other	Total
	non-farmer	11	633	123	61	828
	farmer	261	770	490	127	1,639
Somsa Vanh	All	176	723	364	105	1,362
	non-farmer	361	0	1,295	8	1,664
	farmer	371	0	1,088	144	1,603
Hai	All	367	0	1,158	98	1,623
	non-farmer	1,321	1	1,607	0	2,929
	farmer	17	0	565	187	763
Sang Thon	All	316	0	806	144	1,260
	non-farmer	817	639	329	0	1,785
	farmer	591	265	798	3	1,656
Lon	all	637	341	701	3	1,683
	non-farmer	0	0	0	0	0
	farmer	0	0	262	0	262
Pho	all	0	0	237	0	237
	non-farmer	0	0	0	0	0
	farmer	361	0	1,409	0	1,770
Tad	all	348	0	1,361	0	1,709
	non-farmer	359	402	579	32	1,372
	farmer	291	313	714	94	1,410
Total	all	309	337	679	78	1,400

Table 14: Loans

		No. of loans (%)			amount (1,000 Kip)		
		formal	informal	Total	formal	informal	Total
	non-farmer	70.9	17.3	76.4	2,057.3	437.9	2,499.3
	farmer	73.6	10.4	75.9	2,463.4	103.5	2,567.4
Somsa Vanh	all	72.7	12.7	76.1	2,325.1	217.8	2,544.2
	non-farmer	6.5	41.3	47.8	73.9	875.0	948.9
	farmer	17.6	33.0	44.0	514.2	804.9	1,328.1
Ban Hai	all	13.9	35.8	45.3	365.3	828.5	1,199.8
	non-farmer	21.4	17.9	39.3	775.0	135.7	910.7
	farmer	47.9	23.4	60.6	1,418.0	1,057.3	2,475.3
Sang Thon	All	41.8	22.1	55.7	1,270.4	845.8	2,116.2
	non-farmer	50.0	10.0	53.3	688.3	1,731.7	2,420.0
	farmer	69.0	6.9	71.6	1,995.0	472.8	2,467.8
Lon	All	65.1	7.5	67.8	1,726.5	731.5	2,458.0
	non-farmer	0.0	60.0	60.0	0.0	756.0	756.0
	farmer	4.3	19.1	23.4	212.8	210.6	423.4
Pho	All	3.8	23.1	26.9	192.3	263.1	455.4
	non-farmer	0.0	0.0	0.0	0.0	0.0	0.0
	farmer	8.9	17.9	26.8	133.9	807.1	941.1
Thad	All	8.6	17.2	25.9	129.3	779.3	908.6
	non-farmer	46.2	22.2	61.5	1,227.3	669.5	1,899.8
	farmer	49.4	16.4	59.6	1,544.4	494.4	2,040.4
Total	All	48.5	17.9	60.1	1,460.7	540.6	2,003.3

Table 13 reports the amount of savings made in the previous year. It suggests that total savings per household do not differ very much between the villages or regions, averaging 1.3 to 1.7 million Kip, with the exception of Ban Pho in Luang Namtha Province. However, the composition of savings is quite different. For example, households in Ban Hai and Ban Thad tend to save more in the form of gold, while households in Ban Lon seem to balance their savings between the bank, the saving group, and gold. The status of paddy holdings does not appear to show any consistent tendency regarding savings. However, we can categorize the villages into three types according to the total amount of savings with relation to paddy-holdings; (i) no difference: Ban Hai, Ban Lon; (ii) farmers save more: Ban Somsa Vanh, Ban Pho, Ban Thad; (iii) non-farmers save more: Ban Somsa Vanh.

As for borrowing, we can observe from Table 14 that on average, about 60% of the households borrowed at least once in the past three years, the amount borrowed being about 1.6 million Kip per resident household. Moreover, we notice that there is a regional difference in borrowing: households in Luang Namtha (Ban Pho and Ban Thad) are less likely to borrow than those in Vientiane Municipality. It also seems that the percentage and amount of borrowing is considerably higher in the villages that have a saving group (Ban Somsa Vanh and Ban Lon). We will consider the effect of the saving group in the next section. Borrowing in our sample villages seems not to differ according to paddy-holding status except in Ban Lon, where non-farmers borrow approximately twice as much as farmers.

3.2 Where are the loans from?

Table 15 shows the percentage of households who had borrowed at least once in the past three years, from various lenders. We can see that the saving group (if available) and the APB (Agricultural Promotion Bank) are the major lenders of formal loans, both in terms of the number of loans and the amount, while relatives are the major informal lenders. Households living in a village with a saving group are likely to rely more on the saving group than on other lenders. The percentage of households borrowing from informal lenders in a village with a saving group is likely to be lower than in a village without a saving group. This is because only five to six percent of the households borrowed from relatives. As for formal loans, we can observe a relatively high percentage of households that had borrowed from the APB in Vientiane (Ban Hai and Ban Sang Thon), but not in Luang Namtha. This may be due to ease of geographical/physical access to the APB branch, or a difference in the marketing efforts made by the bank. It is notable that in Ban Hai money lenders dominate a certain proportion (58%) of the loans in terms of amount. This is due to a “maize fraud” scam in which the farmers borrowed money from a trader who asked them to grow maize. Again, we do not find any significant and consistent difference in lenders dependent on paddy-holding status.

Table 15: Sources of loans

		Formal				Informal				
		SG	APB	Others	Total	Family	relatives	friends	Money lender	Total
Number of loans (%)										
Somsa Vanh	Non-F	70.9	0.0	1.8	**70.9**	7.3	5.5	2.7	1.8	**17.3**
	Farmer	73.1	0.5	1.4	**73.6**	4.2	4.7	1.4	0.0	**9.9**
	All	72.4	0.3	1.6	**72.7**	5.3	5.0	1.9	0.6	**12.4**
Ban Hai	Non-F	0.0	6.5	0.0	**6.5**	4.3	23.9	8.7	6.5	**41.3**
	Farmer	0.0	16.5	1.1	**17.6**	5.5	14.3	3.3	11.0	**33.0**
	All	0.0	13.1	0.7	**13.9**	5.1	17.5	5.1	9.5	**35.8**
Sang Thon	Non-F	0.0	17.9	3.6	**21.4**	3.6	10.7	0.0	3.6	**17.9**
	Farmer	0.0	41.5	6.4	**47.9**	3.2	18.1	1.1	1.1	**23.4**
	All	0.0	36.1	5.7	**41.8**	3.3	16.4	0.8	1.6	**22.1**
Lon	Non-F	46.7	3.3	0.0	**50.0**	0.0	10.0	0.0	0.0	**10.0**
	Farmer	63.8	9.5	0.9	**69.0**	0.0	5.2	0.9	0.9	**6.9**
	All	60.3	8.2	0.7	**65.1**	0.0	6.2	0.7	0.7	**7.5**
Pho	Non-F	0.0	0.0	0.0	**0.0**	0.0	60.0	0.0	0.0	**60.0**
	Farmer	0.0	4.3	0.0	**4.3**	6.4	12.8	0.0	0.0	**19.1**
	All	0.0	3.8	0.0	**3.8**	5.8	17.3	0.0	0.0	**23.1**
Thad	Non-F	0.0	0.0	0.0	**0.0**	0.0	0.0	0.0	0.0	**0.0**
	Farmer	0.0	8.9	0.0	**8.9**	1.8	16.1	0.0	0.0	**17.9**
	All	0.0	8.6	0.0	**8.6**	1.7	15.5	0.0	0.0	**17.2**
Total	Non-F	41.6	4.1	1.4	**46.2**	5.0	11.8	3.2	2.7	**22.2**
	Farmer	37.2	11.9	1.8	**49.4**	3.4	9.9	1.3	1.9	**16.2**
	All	38.4	9.8	1.7	**48.5**	3.8	10.4	1.8	2.2	**17.8**
Amount										
Somsa Vanh	Non-F	1,944	0	12	**1,956**	353	55	6	6	**420**
	Farmer	2,182	248	27	**2,459**	38	39	16	0	**93**
	All	2,101	163	22	**2,288**	146	44	13	2	**205**
Ban Hai	Non-F	0	74	0	**74**	29	333	35	435	**832**
	Farmer	0	257	152	**410**	19	261	24	479	**783**
	All	0	195	101	**297**	22	285	28	464	**799**
Sang Thon	Non-F	0	771	4	**775**	11	27	0	9	**46**
	Farmer	11	624	97	**731**	16	401	1	43	**462**
	All	8	658	75	**741**	15	315	1	35	**366**
Lon	Non-F	622	67	0	**688**	0	1,682	0	0	**1,682**
	Farmer	844	235	7	**1,086**	0	160	3	9	**171**
	All	798	200	5	**1,004**	0	473	2	7	**482**
Ban Pho	Non-F	0	0	0	**0**	0	156	0	0	**156**
	Farmer	0	213	0	**213**	49	55	0	0	**104**
	All	0	192	0	**192**	44	65	0	0	**109**
Tad	Non-F	0	0	0	**0**	0	0	0	0	**0**
	Farmer	0	134	0	**134**	54	191	0	0	**245**
	All	0	129	0	**129**	52	184	0	0	**236**
Total	Non-F	1,048	122	6	**1,177**	183	332	10	94	**620**
	Farmer	910	291	48	**1,251**	27	165	10	79	**281**
	All	946	246	37	**1,231**	68	209	10	83	**370**

3.3 For What Purpose?

Table 16 shows the percentage of loans taken out for a variety of purposes; the table shows the percentage of loans taken out for each purpose in terms of the number of loans and the amount borrowed. We can observe that "agriculture" is the major purpose in terms of number of loans, followed by "other", which includes spending for ceremonial purposes such as a funeral, or for childbirth or loans for business (weaving), and "medical" purposes.

Table 16: Purpose of loan by percentage

	agr.	medic.	Food	educ.	purch.	other	Total
No. of loans (%)							
Somsa Vanh	24.7	15.9	9.5	4.3	6.2	39.4	100.0
Hai	32.6	23.3	8.1	1.2	1.2	33.7	100.0
Sang Thon	70.3	18.9	7.2	0.9	1.8	0.9	100.0
Lon	52.4	14.6	5.5	1.8	9.8	15.9	100.0
Pho	7.7	61.5	7.7	0.0	7.7	15.4	100.0
Tad	60.0	13.3	13.3	0.0	6.7	6.7	100.0
Total	36.1	17.3	8.4	3.0	5.8	29.2	100.0
amount (%)							
Somsa Vanh	15.8	6.1	4.4	3.9	14.0	55.8	100.0
Hai	25.7	16.1	7.3	0.9	1.4	48.6	100.0
Sang Thon	34.6	17.4	6.1	4.7	5.6	31.5	100.0
Lon	24.7	8.8	4.5	4.0	11.7	46.3	100.0
Pho	4.0	19.6	5.5	3.4	24.5	43.1	100.0
Thad	22.5	11.7	6.6	6.0	13.6	39.7	100.0
Total	21.6	9.8	5.0	3.8	11.1	48.6	100.0

Table 17: Purpose of loan by amount (1,000 Kip)

		agr.	medic.	food	educ.	purch.	other	Total
Somsa Vanh	Non-F	115	195	180	73	525	1,400	2,499
	Farmer	547	134	75	112	264	1,424	2,567
	All	400	155	111	98	353	1,416	2,544
Hai	Non-F	65	98	159	4	26	597	949
	Farmer	433	240	51	14	12	569	1,328
	All	308	192	87	11	16	578	1,200
Sang Thon	Non-F	780	23	36	9	9	54	911
	Farmer	719	472	158	126	151	851	2,475
	All	733	369	130	99	118	668	2,116
Lon	Non-F	202	145	30	15	38	1,990	2,420
	Farmer	713	234	130	119	352	919	2,468
	All	608	216	110	98	287	1,139	2,458
Pho	Non-F	60	76	60	60	60	440	756
	Farmer	14	90	21	11	117	170	423
	All	18	89	25	15	112	196	455
Thad	Non-F	0	0	0	0	0	0	0
	Farmer	212	110	63	56	128	373	941
	All	204	106	60	54	123	360	909
Total	Non-F	199	142	133	42	275	1,107	1,900
	Farmer	517	215	89	88	202	924	2,040
	All	433	195	101	76	221	972	2,003

Table 17 shows the average amount of loans for each purpose per resident household. Again, we see that households borrow more for “other” and “agriculture” purposes. However, it is also notable that households also borrow for the purpose of “purchase”, such as the purchase of a motor-bike or the purchase of lumber for house construction, especially in Ban Somsa Vanh and Ban Lon.

There are some signs of intra-village difference according to paddy-holding status. For example, it is likely that a higher percentage of loans for “food” consumption is taken out by non-farmers because they do not produce food for themselves. This can be confirmed in Ban Somsa Vanh, Ban Hai, and Ban Pho, but not in the other villages. Conversely, farmers tend to borrow more for other purposes than non-farmers.

4. The Impact of A Saving Group

This section analyzes the impact of the saving group on saving and borrowing behaviors in our study area. Our method of assessing the impact of the saving group is essentially to compare the average of key indicators from a village with a saving group with the average from those villages without a saving group. To do this, we first divided our sample villages by region: Vientiane and Luang Namtha. Then, in each region, we divided the villages into two subgroups: a village with a saving group (SG-village) and villages without (non-SG villages). Then, we calculated the average of the key indicators by subgroup in each region and conducted a Welch two-sample *t* test to examine whether true differences in the average between the subgroups are statistically significant. Hereafter, we employ $p<0.05$ as a confident level to reject the null hypothesis that the average of an indicator is equal between the subgroups.

It is worth emphasizing, however, that the results are very preliminary and require careful interpretation. Readers should keep in mind the following points. First, what we see as the impact of a saving group here could also be possibly capturing village fixed-effects, because the SG-village is equivalent to Ban Somsa Vanh and Ban Lon. Thus, even if we do find significant differences between the subgroups, they may not be totally due to the existence of a saving group but also due to some specific characteristic of the village, such as land type or availability of irrigation. Second, strictly speaking, all of the independent variables below are subject to other household and village characteristics, rather than just the impact of a saving group alone. Thus, it is necessary to control for these factors before making any conclusions on the impact of the saving group.

4.1 Impact on saving

Table 18 compares the amount of savings in villages with and without a saving group in Vientiane and Luang Namtha. The Welch two-sample *t* test is carried out on the assumption that the amount of savings is distributed normally, to test whether there are true differences in average savings between the subgroups.

Table 18: Impact of Saving Group on Savings (1,000 Kip)

	bank	SG	gold	other	total	monetary
Vientiane						
mean (with SG)	175.98	722.74	363.95	104.61	1,361.66	956.34
mean (without SG)	343.36	0.23	992.85	119.63	1,452.24	343.59
t-value	-0.93	11.70	-2.78	-0.21	-0.24	3.14
p-value	0.35	0.00	0.01	0.83	0.81	0.00
df	386.53	319.00	322.27	544.32	375.01	475.08
Luang Namtha						
mean (with SG)	637.00	341.50	701.45	2.74	1,682.68	978.50
mean (without SG)	183.64	0.00	829.18	0.00	1,012.82	183.64
t-value	1.47	4.88	-0.50	1.00	1.56	2.32
p-value	0.14	0.00	0.62	0.32	0.12	0.02
df	185.49	145.00	184.24	145.00	243.92	177.49

The results of the test suggest that savings in terms of gold are lower in a SG-village than in non-SG-villages in Vientiane (p=0.01). However, this is not true in Luang Namtha (p=0.62) or for other forms of savings. It is quite obvious that a saving group would increase monetary savings or savings in cash. The last column of Table 18 confirms this intuition. A saving group in the village almost triples the monetary savings, which is the sum of savings in banks and the saving group, and this difference is statistically significant.

The saving group also seems to have affected saving portfolios or the allocation of extra income. We asked how the interviewee's household would allocate an additional hundred US dollars. Table 19 shows that on average, households living in a SG-village would allocate approximately one-third of this money to the saving group. How then, would these households save if there were no saving group?

Table 19: Saving portfolio (%)

		home	bank	SG	gold	cattle	buy	debt	others
	Non-F	28.4	0.9	29.8	0.6	8.5	10.2	2.1	19.4
	farmer	24.2	1.4	38.3	0.5	7.6	8.5	2.2	18.3
Somsa Vanh	All	25.6	1.2	35.4	0.5	7.9	9.1	2.2	18.7
	Non-F	24.3	6.5	0.0	3.3	5.7	15.0	0.2	45.4
	farmer	29.5	0.0	3.1	3.6	14.0	10.7	1.9	36.4
Hai	all	27.7	2.2	2.0	3.5	11.2	12.1	1.3	39.5
	Non-F	20.7	5.4	0.0	0.0	40.7	11.8	1.1	20.4
	farmer	26.2	3.0	3.4	0.0	29.0	13.5	0.3	25.6
Sang Thon	all	24.9	3.5	2.6	0.0	31.7	13.1	0.5	24.4
	Non-F	11.7	1.7	28.7	0.0	10.0	20.7	0.0	27.3
	farmer	25.1	0.9	35.7	0.0	14.4	6.1	0.9	17.0
Lon	all	22.3	1.0	34.2	0.0	13.5	9.1	0.7	19.1
	Non-F	42.0	0.0	0.0	0.0	30.0	18.0	0.0	10.0
	farmer	40.6	3.2	2.1	0.0	19.1	25.1	1.5	8.3
Pho	all	40.8	2.9	1.9	0.0	20.2	24.4	1.3	8.5
	Non-F	25.0	0.0	0.0	0.0	50.0	25.0	0.0	0.0
	farmer	42.1	3.2	3.6	0.9	24.5	16.8	0.0	8.9
Thad	all	41.6	3.1	3.4	0.9	25.3	17.1	0.0	8.6
	Non-F	24.6	2.7	18.7	1.0	13.1	13.1	1.2	25.6
	farmer	28.3	1.6	21.4	0.8	15.5	11.1	1.3	20.3
Total	all	27.3	1.9	20.7	0.8	14.9	11.7	1.3	21.7

Table 20: Impact of saving group on portfolio choice (%)

	home	bank	SG	gold	cattle	buy	debt	others
Vientiane								
mean (with SG)	25.64	1.21	35.44	0.51	7.92	9.06	2.16	18.70
mean (without SG)	26.41	2.82	2.32	1.85	20.85	12.59	0.93	32.37
t-value	-0.27	-1.51	17.08	-1.63	-4.91	-1.76	1.55	-4.25
p-value	0.79	0.13	0.00	0.10	0.00	0.08	0.12	0.00
df	514.97	403.29	456.84	320.10	414.93	453.41	571.97	477.74
Luang Namtha								
mean (with SG)	22.33	1.03	34.25	0.00	13.49	9.11	0.68	19.11
mean (without SG)	41.18	3.00	2.73	0.45	22.91	20.55	0.64	8.55
t-value	-3.88	-1.39	8.96	-1.00	-2.15	-3.04	0.07	2.78
p-value	0.00	0.17	0.00	0.32	0.03	0.00	0.94	0.01
df	202.83	154.25	197.01	109.00	196.44	187.64	248.09	246.27

Table 20 reveals that the saving group reduced savings in terms of cattle and “others” in Vientiane, while in Luang Namtha it reduced savings or usage in terms of cattle, “purchase of durable goods”, and “keeping at home”. This result possibly suggests that cattle are one of the major sources of savings, but it is less preferred than the saving group. However, we must emphasize that the results regarding cattle in Vientiane may be exaggerated because the villagers in Ban Sang Thon, a non-SG village, were eager to promote cattle-raising since there is rich grassland suitable for this purpose.

4.2 Impact on borrowing

Table 21 compares the amount of borrowings from various lenders in a manner similar to that in Table 18. The average size of loans from formal lenders is higher in a SG-village than in non-SG-villages in both regions, and this result is statistically significant. It can also be confirmed that the average size of loan from informal lenders is lower in the SG-village in Vientiane. This is due to smaller loans from relatives and money lenders. However, the average size of loans from money lenders may be due to village-specific reasons, in that the villagers suffered from a “maize fraud” in Ban Hai. Unlike Vientiane, there is no statistically significant impact on informal loans in Lunag Namtha, which could imply that informal lenders are still important sources of loans there. In both regions, the average total loan is higher in the SG-village.

Table 21: Impact of a saving group on lender (1,000 Kip)

formal lender	SG	bank	APB	others	total
Vientiane					
mean (with SG)	2,101.36	9.01	163.04	13.01	2,287.58
mean (without SG)	3.86	86.1	413.86	2.66	506.84
t-value	8.48	-1.37	-1.42	1.19	5.79
p-value	0	0.17	0.16	0.23	0
df	319.16	268.3	482.61	356.45	391.13
Luang Namtha					
mean (with SG)	798.08	3.42	200.34	2.05	1,003.9
mean (without SG)	0	0	159.09	0	159.09
t-value	8.97	1.39	0.45	1	6.7
p-value	0	0.17	0.65	0.32	0
df	145	145	228.57	145	241.71

informal lender	family	relatives	friend	money lender	total	Grand total
Vientiane						
mean (with SG)	145.65	44.41	12.7	1.96	204.72	2,493.58
mean (without SG)	18.73	299.13	15.18	262.28	595.32	1,104.47
t-value	1.48	-2.79	-0.26	-2.48	-2.42	3.96
p-value	0.14	0.01	0.8	0.01	0.02	0
df	325.14	280.26	572.41	258.1	454.31	487.77
Luang Namtha						
mean (with SG)	0	472.6	2.05	6.85	481.51	1,485.41
mean (without SG)	48.18	128	0	0	176.18	335.27
t-value	-1.57	0.98	1	1	0.86	3.03
p-value	0.12	0.33	0.32	0.32	0.39	0
df	109	150.17	145	145	152.12	160.89

Table 22: Impact of a saving group on purpose of loan (1,000 Kip)

	agr.	medic.	food	educ.	purch.	other	Total
Vientiane							
mean (with SG)	399.74	155.14	110.84	98.29	353.42	1,415.86	2,544.21
mean (without SG)	509.02	275.43	107.30	52.32	64.29	620.46	1,633.15
t-value	-0.81	-1.32	0.09	1.11	2.61	2.61	2.25
p-value	0.42	0.19	0.93	0.27	0.01	0.01	0.03
df	549.04	313.78	542.17	457.18	343.96	506.17	575.23
Luang Namtha							
mean (with SG)	608.22	215.89	109.59	97.95	287.33	1,139.04	2,458.01
mean (without SG)	116.36	98.00	43.64	35.91	117.73	282.73	694.36
t-value	5.03	1.58	1.24	1.18	1.20	1.77	2.51
p-value	0.00	0.12	0.21	0.24	0.23	0.08	0.01
df	207.17	221.72	233.35	232.41	210.44	185.17	208.70

Finally, Table 22 shows the average size of loan per household for each purpose. Observe that the average size of loans for “purchase” and “others” is higher in the SG-village than in the non-SG villages in Vientiane. We can estimate that the saving group enabled households to purchase durable goods, such as motor-bikes, and to construct or repair their houses by making it possible for them to borrow five times more for these purposes than those living in non-SG villages were able to borrow. Unlike in Vientiane, the average loan for “purchase” purposes in the SG-village is not significantly higher than in the non-SG villages in Luang Namtha. Instead, loans for “agriculture” are six times higher in the SG-village. A natural interpretation of this result is that the saving group enabled the farmers to adopt new HYV seeds and to use more fertilizers and pesticides.

The average total loan per household was significantly higher in the SG-village in both regions. Two interpretations of this result are possible. First, a positive interpretation is that the saving group has fulfilled the potential demand for loans, which would not have been possible without it. In this sense, the saving group has mitigated the members’ credit constraints. Second, a negative interpretation is that the saving group has expanded an unnecessary demand for loans by giving the members access to an additional source of loans.

4.3 Discussion

We have attempted to assess the role of the saving group in borrowing and saving in two study sites. However, the impact of a saving group cannot be determined exactly because we are unable to identify the effect of the saving group from the characteristics of the village. Yet, some interim observations and implications can be derived with some degree of confidence. We can summarize them as follows:

1. The saving group seems to offer a new and well-functioning method of savings and increased savings in terms of cash. This is important because the liquidity and fungibility of cash enables the easier mobilization of savings.
2. The saving group seems to take the place of informal loans, especially by reducing loans from relatives. An evaluation of this point is still open, since fewer loans from relatives may weaken communal ties.
3. The saving group seems to have a positive role in facilitating consumption in the face of fluctuating income. However, assessment of this consumption smoothing cannot be conducted without a panel data, since we need at least two intertemporal data, for consumption and income.
4. The saving group seems to have enabled households to purchase durable goods and to adopt new agricultural technologies.

Overall, in general, a saving group seems to have a positive impact through the smoothing of consumption, the purchase of durable goods, the adoption of new technology, and by providing an opportunity to save in cash.

Concluding Remarks: Policy Implications

Microfinance is a concept that has gained widespread acceptance by international development agencies and donors. Microfinance can be classified into two types: the out-reach type and the targeting-the-poor type. The village saving groups of Lao-FIAM discussed in this paper fall into the out-reach type. From another viewpoint, microfinance schemes can be dichotomized into the saving-based type and the external fund-based (credit subsidy) type. The Grameen Bank of Bangladesh can be characterized as a targeting-the-poor, external fund-based type, while the FIAM saving groups of the Lao PDR fall into the category of an out-reach, saving-based type. The FIAM saving groups in Thailand as discussed in the Appendix differ from Lao-FIAM saving groups in that the former provide seed money to the groups.

The out-reach type of microfinance is expected to play two important roles in rural economies. One is the mobilization of savings for development (but confined to within the village society), and the other is to satisfy the demand for loans in the village. Our survey revealed that FIAM saving groups are mobilizing savings from rural households at a swift pace and have satisfied funding requirements within villages for several purposes, including agricultural production, rural non-farm income generating activities, education, and possibly consumption facilitation. Most noteworthy is the higher cash savings in the villages with a saving group than in the villages without a saving group. This would provide momentum for the development of the village economy.

It is known that many government-backed microfinance schemes ceased to function properly because they failed to sanction delinquent borrowers. Where enforcement is an issue, as is generally so in many developing societies in a transition to a market economy, the government may intervene by strengthening property rights to enhance the effectiveness of collateral. The Lao-FIAM saving group shows a contrasting picture because of the strong governance of the Lao Women's Union that takes the place of a legal enforcement mechanism. This is where Lao PDR claims an advantage in the field of microfinance. Thus, it can be said that a saving-based type of saving group should be facilitated in the Lao PDR. Needless to say, the Lao Women's Union should participate in the saving group scheme in a disciplined manner.

We must, however, draw attention to the following points for healthy growth of the saving group. As Ban Somsa Vanh has experienced, the deposits exceed the loan demand within the village in the long term. A saving group and its members need to consider how to use and invest surplus deposits. We note three possibilities:

1. The members can establish a village-enterprise like the Chinese Township and Village Enterprises (TVE) and surplus deposits can be used to finance the project. In Thailand, this author observed a village silk-reeling factory financed by the surplus in the village saving group. Government interventions to promote village non-farm household industries are advisable.
2. The members can use surplus deposits to enhance the infrastructure of the village, i.e. schools, roads, village office, irrigation, water pumps, etc. However, these usages do not bring forth monetary benefits (interest receipts) for the members, providing instead physical benefits that can be used. Thus, the members should understand this and discuss whether the projects are appropriate for them.
3. The performance of the saving groups discussed does not go beyond the village society. However, when a surplus is generated, measures must be considered to facilitate the flow of surplus funds to other saving groups where the demand exceeds the deposits, and where higher returns can thus be expected. This is what CODI is planning. When this scheme is successfully launched, the village bank can transform itself into a regional bank. For this purpose, the government must provide a legal basis for the protection of loans.

From a public point of view, it is important to mobilize the excess savings in the rural areas into public infrastructure and growing industries. The postal savings system of Japan has contributed to economic development by linking rural savings to the formal sector. It is extremely important that the government should consider a way to do this without discouraging the members' incentives to save. Furthermore, we know the banking system of the Lao PDR has numerous deficiencies. Before establishing a linkage, it is imperative that the Lao Banking system attain economic viability.

Appendix:

Lessons from the Experiences of Village Saving Groups in Thailand

The out-reach type of savings group developed in Laos by FIAM is a transplant of the Village Saving Group (VSG) of Thailand. The VSG in Thailand has a long history, and also takes various forms. Thus the Thai experience could be extremely telling in forecasting the future of VSG in the Lao PDR, and in considering appropriate government interventions. In order to learn lessons for rural finance in Laos, a survey was carried out covering three types of village saving group in NE Thailand; 1) Government-led groups (CDD type), 2) Individual-led groups, and 3) FIAM saving groups.

I Government-led groups: CDD-type

The formation of VSG (Village Saving Groups) in Thailand was begun in 1974 by the Department of Community Development of the Department of the Interior. This was called 'Saving Groups for Production' (Krum Om-Sap Phua Karn-Pa-Lid). In 1974 VSG was started in two villages in the provinces of Chaing Mai and Asatoon, and the project showed good growth; in 1980 there were 1,354 groups, and in 1993, 9,927 groups. According to the survey carried out by the CDD office in the Province of Khon Kaen, out of a little over 2,000 villages in the province, some 1,433 villages have CDD-type saving groups formed in them.

However, in Thailand it is usual for several types of VSGs to exist in the same village, and many villagers borrow capital from multiple VSGs and formal banks (BAAK). This means that in studying VSGs it is also necessary to compare them with other financial institutions. Taking as our example the village of Non Ngam in Khon Kean Province, which has four VSGs (Table A-1), let us look at the CDD-type of saving group. The survey was carried out mainly by the village head, Ms. M.

Table A-1 Village Saving Groups in Ban Non Ngam

	Village Saving Group	Government Agency in charge	Established Year
1	Farmers' Saving Group (Krum Om Sap Kaseta Karn)	Department of Agricultural Extension	1994
2	CDD Saving Group of Queen's Birthday	Community Development Department	1995
3	CDD Saving Group (Krum Om-Sap Phua Karn-Pa-Lid)	Community Development Department	2000
4	One Million Baht Fund (Kong Ton Nung Lan Baht)	Thai Government	2002

1) Farmers' Saving Group

The Farmers' Saving Group was introduced in 1994 by the Department of Agricultural Extension in order to promote the sericulture industry. However, at the time the survey was taken the reason for borrowing money was not restricted to sericulture; it was possible to borrow money for the purpose of consumption. Each month members deposit a fixed amount of between 10 and 100 Baht, known as Sat-ja Saving (a Buddhist term meaning 'sincerity'). The amount to be saved is indicated by each member at the Annual Meeting held on the April 10. The amount is fixed to facilitate the calculation of deposits and dividends. There are a total of 120 members from 64 households, and at the time the survey was taken total deposits came to 230,000 baht. Considering how long the saving group has been in operation the deposits are low; this is because all the members drew out their deposits in 2000, when it was rumored that dishonesty on the part of the Group's Committee members had made the Group insolvent. After the money had been paid back to the members, they started to make deposits again the following month.

Loans are made only at the time of the Annual Meeting in April. The top limit for a loan is 3,000 baht, but since roughly 100 people want a loan each year and the money is divided up more or less equally among them, the amount loaned to each person is about 2,300 baht. Interest is 3% per month, and the total yearly interest (i.e., 36%) is subtracted from the amount loaned. Thus the actual annual interest rate is in excess of 36%. The income from interest is shared out, 15% to the committee members, 5% to the reserve fund and the remaining 80% to the members. Since almost all the members take out a loan, the actual yearly interest rate is in the region of 8%.

The pre-paid interest goes as capital for emergency loans. These are loans for about 3 months, at 3% interest a month, to a maximum of 2000 baht. Between 7 and 10 members a year apply for these loans.

2) Saving Group of Queen's Birthday

This was established in 1995 by the Community Development Department with 25,000 baht in seed money, to promote weaving. At that time the members acquired stock by investing between 50 and 1000 baht per person, thus increasing the capital to 50,000 baht. The members of this group are silkworm breeders, and the membership is the same as for the Farmers' Saving Group described above.

Loans are for up to 3 months, at 3% interest a month. At present the reason for loans is not restricted to weaving; it is also possible to borrow money for the purpose of consumption. Three percent of the income from the interest is donated to the school or temple, and 97% is divided up among the members according to the size of their investment.

3) CDD Saving Group

The Saving Group that is expanding on a nation-wide scale under the guidance of the CDD was established in this village in 2000. The revolving fund of this saving group is generated from monthly savings, membership fee, interest income from deposits at formal financial institutions, and financial assistance from the CDD. Incidentally, in 2000 Non Ngam village was divided into Non Ngam 1 and Non Ngam 2. The two Village Saving Groups described above, having been established prior to the splitting of the village, cover the finances of both villages. In contrast, the CDD Saving Group was established after the split, so that there is a group established in each village. The survey was carried out in Non Ngam 1 village, which has 64 households.

The majority of households in the village belong to the CDD Saving Group, and at the time of the survey there were 72 members (which means that some households had more than one member). There is a minimum savings obligation of 10 baht per month. The total amount of savings has reached 50,000 baht, which is quite a lot considering the group was only established in 2000. The reason for this, according to the head of the village, is that the villagers have the confidence to save more because other households in the same village are members. The interest on loans is 3%, and a loan is for a term of one year. Eighty percent of the income from interest is distributed to the members as a dividend. Thus the actual interest rate is quite low.

The three Saving Groups described above have been independent of each other from their inception. However, since none of them question the reason for a loan, they all charge the same interest rate and they more or less share the same members, they hold their Annual Meeting at the same time in April each year.

4) One Million Baht Fund

Every household is a member, and there is a monthly savings obligation of 20 baht. The maximum loan is for 20,000 baht. The annual interest rate is 7%, and loans can be made at the Annual Meeting. Principal and interest are repaid one year later. Compared to the other Saving Groups the interest rate is low, but whereas the others return 80% of income from interest as dividends, this Fund returns 20%. Thus, there is no great difference in the actual interest rate. However, loans are limited to production purposes, and a project proposal must be submitted when a loan is made. For this reason not all the members want to take out loans. Rather, many people save with the fund because, if the dividend is seen as interest, the annual rate of 5.6% is better than the banks can offer.

In Thailand, a number of Saving Groups operate side-by-side in the same village, and the villagers are members of multiple VSGs. The CDD Saving Group is particularly widespread. I would like to make the following comments regarding the CDD Saving Group.

Terms for making a loan differ even with the same type of saving group. For example, in a village equipped with irrigation facilities the Saving Group is often a union for the joint purchase of chemical fertilizers. The saving group mobilizes the money it has collected and uses it to make a bulk purchase of chemical fertilizer, which is then handed on to its members. After the harvest the members repay the cost of the fertilizer, plus interest, to the saving group. Or even if it does not go that far, in villages where rice is the main crop, the period of a loan is set at half a year. In contrast to this, where non-agricultural activities such as weaving prosper (that is, in non-irrigated areas, where rice production does not flourish), the loan term is generally 3 months. In groups where demand is always in excess of total savings the annual interest rate is 3%, but there is a tendency for the interest rate to drop to 2% when the savings have grown somewhat. In other words, the interest and loan term are not uniform, but dependent on the circumstances of the village. To put it another way, government involvement to regulate the saving groups uniformly should be avoided.

The village has a number of saving groups, and Thai farmers also have access to banks, typically the BAAC. For this reason, the farmers generally borrow from several financial institutions. Loans to pay back debt are not recognized by the saving groups. However, the committee heads of the saving groups admit that borrowing to repay debt is becoming entrenched. The merit of the Village Saving Group is that a loan can be obtained more easily than from an urban-type financial institution, but it should be noted that this has both advantages and disadvantages.

Further, as can typically be seen in the CDD Saving Group, it seems that with the formation of too many saving groups, monitoring by the CDD is not carried out properly. There are tales of groups breaking up because of corruption. As a means of avoiding corruption, different committee members are put in charge of savings, loans and repayments, so that information does not become concentrated in the hands of one person. The same happens with saving groups in Laos; this system is essential for preserving the transparency of the saving group’s accounts. Since only a limited number of cases were surveyed it is impossible to be conclusive, but since there is insufficient monitoring of the system for the establishment of VSG (especially CDD), the success or otherwise of a VSG depends a lot on the leadership of those responsible for the VSG. The case that follows demonstrates the importance of that leadership.

II VSG established by individuals (KNSG)

The VSG in Ban Known Noi (367 households) in the Province of Chaiyapoon (which will be referred to as KNSG) was set up in August 1987 by the principal of the village elementary school, following the style of the CDD VSG.[1] The village has 14 trucks for transporting vegetables, and is a base for the supply of vegetables to the major city of Nakhon Rachashima, 2 hours distant by road in NE Thailand.[2]

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1 This school principal is the sub-chairperson of KNSV, and receives a monthly salary of 1200 baht. His salary as a school principal is 40,000 baht per month. The chairman of KNSV receives a salary of 1300 baht.

2 Approximately 70% of arable land is used for vegetable cultivation.

At the time of the survey in March 2004, the group had 597 members in August 2003. This was because no new members had been admitted for the previous four years; when new members were later admitted, the number of members at the time of the survey was 999. Some households have more than one member, and seen in terms of the number of households approximately 10% of households are not members of KNSG. This 10% comprises those who are affluent enough not to need the VSG, those too poor to afford the monthly savings, and those who have resigned from the VSG. 3For the regulations of KN VSG, see Appendix 1

KN VSG holds its annual meeting in September, at which the members determine their monthly savings (Sat-ja) for the coming year. Having a fixed amount of savings each month facilitates accounting. Members' monthly savings range from 10 to 500 baht. Loans have a monthly interest rate of 1.5% (18% pa), and the loan is for a term of one year.4 However, the amount that can be borrowed is no more than the amount one has saved; borrowing more than that requires the consent of other members and one's own savings as security (see Appendix 2, 'Loan Documents'). This means that this is unsecured financing. Even so, the maximum total loan possible is 50,000 baht. Loans may be taken out several times a year until this limit is reached. Interest is paid every month, and the principal is repaid at the end of the loan term. If repayment is not possible, the loan may be converted up to two times. Reasons for taking out loans are mainly related to farming, but loans are also used as capital for those going to work abroad (in Taiwan, South Korea, Singapore, Japan), to purchase a tractor or to go towards repayments to BAAC.

Since 74% of the Group's income from interest is distributed to members as a dividend, the actual interest rate is 4.68 %(18 x 0.26). If interest payments fall so much as one month in arrears the member loses his right to receive the dividend, and so must pay the annual interest rate of 18%. The regulation provides a strong incentive to pay the interest on time each month.

In 2001 the Group began the joint purchase of chemical fertilizers and other supplies. For example, a member buys a 420 baht bag of chemical fertilizer on credit through the Group, and half a year later repays 450 baht. The additional 30 baht is the interest payment, which makes the annual interest rate the equivalent of 6.7%.

At the time of the survey in March 2004 total savings came to 12.4 million baht, of which 10 million baht was being loaned out to members, there were emergency loans of 240 thousand baht and 438 thousand baht was being used to pay for the purchase of fertilizer. The remainder was deposited in the bank at 0.75% interest.5

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3 The regulations of the KN Saving Group (see Appendix A) state, 'The re-registration of a person who has resigned from the group will not be recognized'. Around the time the group was established, close on 20 members resigned from the group on the grounds that money was being used dishonestly. These people wish to participate once again, but the regulations do not allow them to.

4 When we asked whether a loan term of one year was not too long considering that most of the loans were for farming purposes, the answer was that half a year would certainly be long enough, but it would make the book-keeping too complicated.

5 An emergency loan, with a monthly interest rate of 1.5%, is limited to a maximum of 3000 baht and is for a term of half a year.

This village has a Cooperative and a One Million Baht Fund. Many of the villagers also have loans from BAAC. The annual interest rate for loans from the Cooperative or BAAC is 9%, and the term is one year. The interest is rather high, and collateral is also taken. A loan can be taken out only once a year. In contrast to this, the actual interest rate for KNSV is 4.68% because of the dividend; the loans are without collateral, and any number of loans can be taken out up to the maximum loan. This is the driving force behind the KNSG. Thus it is usual for villagers to borrow first from KNSV, and when they reach the maximum to rely on other financial institutions. The One Million Baht Fund has an interest rate of 6%, borrowing is done once a year, and the money is loaned evenly between the applicants, so that compared with KNSG the amount borrowed per person is low. This is because KNSG has huge deposits of money. As will be explained below, problems arise in VSGs with meager deposits.

KNSV is an example of success due to the strong leadership of the founder. As can be seen in the attitude whereby those who have left are not allowed to rejoin the group, the founder takes great pains to maintain discipline. The KNSV system is basically the same as that for the CDD Saving Group, so it can be said that that this is an example showing how leadership has a lot to do with the success or otherwise of a saving group.

The most noteworthy feature of KNSV is the Annual Report distributed to the members, which discloses not only the detailed financial situation of the Group, but also the names of all group members together with the amount saved, amount borrowed and amount received as dividend by each member. This preserves the transparency of the Group's accounts. Of all the groups covered by the survey, KNSV was the only one to put out an Annual Report.

Things are going smoothly for KNSG, but for that very reason two problems have arisen. What follows is taken from an interview with the founder.

The first problem is that because of the high dividend rate of 13.32 %(18x0.7), savings have reached the huge sum of 12.3 million baht. The interest rate on deposits in Thai banks is extremely low, at 0.75%, and the huge deposits are a result of farmers putting their money in KNSG instead of in a formal bank. However, the Thai government is apprehensive that because the deposits are so large, any mismanagement that might arise would have a huge effect on village society, and is instructing the group to register itself as a cooperative. However, registration would necessitate hiring at least three full-time officials, each of whom would have to be paid a monthly salary of 4100 baht. At present the only salary is the 1300 baht paid to the Group Chairman. Registration would also mean changing over to the government accounting system. Committee members would be unpaid, and unable to participate in the management of the Group. At the August 2004 Annual Meeting the members expressed their opposition to registration.

The second problem is that because the deposits have grown so large, thought must be given to the purpose for which the funds are used. Because the amount is so large, loans for consumer purposes must be handled carefully. In other words, without an undertaking from which sufficient income can be expected, it will not be possible to maintain the present high dividends. For this reason the founder is suggesting to the members that the lending interest rate be lowered, but the members who are counting on their dividends are opposed to this. This being the case, for the time being total deposits have been limited to a maximum of 200,000 baht. At the time of the survey, five members had reached this limit, and no more deposits were being accepted from them. The same problem is arising in Laos. It is only a question of time before there are calls for a lid to be placed on monthly deposits and/or total deposits.

III FIAM Saving Group

FIAM, a Thai NGO, was established in 1985. At first sixty villages in the Province of Roi-et engaged in all sorts of activities, including lunches for local schools, a revolving fund for agricultural activities (mainly fish culturing) the improvement of health conditions such as the provision of toilets and jars for drinking water, a buffalo bank, etc. Later, between 1994-97 three villages in the Province of Roi-et started a saving group (Kum Om Sap). Funds were provided by the CRS (Catholic Relief Service, USA). The funds from the CRS were not a gift, but a loan at 3% annual interest. Since 1998 the group has worked on the development of a savings bank.

As of the time of the survey in September 2004, there were VSGs in a total of 127 villages; 60 in Roi-et Province, 26 in Ubon Province, 23 in Korat Province and 18 in Udon Province. Although there is a longer history of activity than in Laos, the reason why the number of VSGs is not growing is as follows.

Laos-FIAM meets its operating costs with financial aid from the developed nations (CEDA and CODI). It follows that there is no need to transfer funds from the VSG. In contrast, Thai-FIAM obtained loans from the CRS (Catholic Relief Service: USA), on which interest must be paid, at the rate of 3% pa until 1999 and at present at a rate of 7.5-9% pa. FIAM loans out these funds as seed money for the establishment of VSGs at an annual interest rate of 18% (initially 12%), and the difference is FIAM's source of funds. The term is half a year, and so the term for loans to villages is also half a year.

Seed money is used when a saving group is established to provide the first loan of 1,500 baht per member. The members are required to make a savings deposit each month, so that VSG funds are from two sources, the loans from FIAM (external account loans) and members' savings (internal account loans). Group members co-guarantee each others' loans, and no actual security is required. For each subsequent loan cycle, the member is entitled to borrow an amount equal to her previous loan plus her accumulated savings in the village bank. When a sufficient amount has been saved in the internal accounts, the injection of funds from FIAM is terminated (generally 5 years after establishment)

For example, of the 60 FIAM-Saving Groups set up in the Province of Roi-et, half no longer receive external loan assistance from FIAM. This means that in order to survive, FIAM must establish new saving groups. Leaving the problems facing Thai-FIAM to be described later, let us look at the situation in a village that has graduated from the FIAM external loans, and in a village still receiving funding.

1) FIAM graduated village

In Ban Don Kho in the Province of Roi-et, a CDD saving group was set up in 1989. In 1991 the VSG was not being properly maintained by CDD; an approach was made by FIAM and the VSG became a FIAM Saving Group. At the time it was established the Group had 21 members, and now has 58. This village has a Saving Group (2000) created by the Department of Agricultural Extension (DOAE), a Mushroom Cultivator Group (2001) and a One Million Baht Fund (2002) saving group.

Of these, let us take a look at the One Million Baht Fund. A villager can become a member by paying the 10 baht admission fee. A further 10 baht is paid for every 1,000 baht borrowed (in other words, the interest rate is a mere 1%). Thus, strictly speaking this is not a saving group (this Fund takes many forms; in other villages making savings deposits is a condition for taking out a loan). The upper limit for a loan is 20,000 baht, the annual interest rate is 6%, and the term of the loan is one year.

As of September 2004, the FIAM saving group held total deposits of 1.012 million baht (17,455 baht per person). There is a minimum savings requirement of 20 baht per month. Loan interest is 2% per month (24% annually), and the term of the loan is one year. Loans are made every month, but all loans must be repaid in December when the accounts are closed. Loans are unsecured, but two members must stand guarantor. The maximum loan available is 4 times the amount of the member's savings (the savings of the two guarantors may be added to the total), but at the present time because of the large number of loan applicants this is restricted to between 8,000 and 10,000 baht per person, less than half that of the One Million Baht Fund.

The peak borrowing periods are the rice-planting season in June, the start of the school term in May and October, and March, the month when repayments to the BAAC fall due. The peak period for repayment of loans is April, when sons and daughters working away from home return for the Thai New Year, bringing money with them. In this village roughly 70% of households have family members who are migrant workers (most of them factory workers in Bangkok).

The differences between the One Million Baht Fund and FIAM Saving group are as follows. Larger amounts can be borrowed from the former, and the interest is low; but the loan formalities must be completed at a bank in the town, and the application for a loan must be made by October. In contrast, the amount that can be borrowed from the FIAM Saving Group is smaller, but any number of loans may be taken out as long as the total is within the limit. Loan formalities are completed in the village. In other words, there is some distinction between the two within the financial market.

Ban Nong Rai : a VSG receiving funds from FIAM

In 1998 a CDD saving group was set up in Ban Nong Rai, a small village of 50 households, and in 2000 FIAM came in and turned it into a FIAM Saving Group. In 1998 the Group had 32 members, and at the time of the survey in September 2004 this number had dropped to 29 members.

The amount of funding from FIAM was 27,000 baht in the first part of 2004, and 17,000 baht in the second part (from September on). Total deposits come to 39,000 baht, which is only 1360 baht per person. Both the funding from FIAM and members' savings are used as capital for loans, but the conditions for loans differ as shown in the following table.

	Term	Interest rate	Ceiling
FIAM Fund	6 months	2%/ month	7,500
Saving	12 months	2%/month	10,000

The upper limit for a loan from savings is 10,000 baht according to the regulations, but since the total amount of savings is low and many people wish to borrow money, the amount that can be loaned to each person is only a little over 1,000 baht. In the case of FIAM loans too, if we take the first part of 2004 as an example, since the amount of funding was 27,000 baht, there was no more than a little less than 900 baht per person available. Every household also takes out loans from BAAC. This village is engaged in tobacco production, and receives loans of 2,500 baht per *rai* from BAAC. [6] In addition, the One Million Baht Fund also started up in December 2002. Members must deposit 10 baht per month, but loans of up to 20,000 baht (for 50 households) may be made, at an annual interest rate of 6%.

As we can see, the size of loans from the FIAM Saving Group is extremely small compared with loans from BAAC or the One Million Baht Fund. For this reason membership of FIAM has started to fall, especially since the establishment of the One Million Baht Fund. Members' motivation to save has also fallen, and many members deposit no more than the minimum 20 baht per person per month.

Tentative conclusions

Micro-finance in Thailand became popular in the form of the savings-based VSG. In that sense, it can be said that the VSG has played an important role in mobilizing savings in the rural villages. In Japan the

6 Costs for tobacco production are 800-1000 bhat/*rai* for chemical fertilizers and 1500 B/rai for pesticides. Seed is self-supplied. Crude production is 50-60,000 baht/*rai*.

attempt to mobilize savings in the rural villages has taken the form of post-office savings. Since this was organized on a nationwide scale, these savings were macro-finance deposits, and were used to fund economic development. In contrast, the VSG of Thailand and Laos basically take the form of a segmented village financial market in the limited region of a single village. In Laos, when a VSG created by CODI (Thai) has a savings surplus, it is starting to happen that CODI acts as a go-between to lend the surplus to other saving groups with insufficient funds. Further, in Ban Somsa Vanh, a village covered by the survey, the amount of savings has become greater than the members' demand for funding, and they have started to make loans to other VSGs. In other words, there is the possibility of the segmented markets becoming linked, that is, the future possibility of a regional bank. There will undoubtedly be a need for measures to protect legally the monies loaned then.

However, a number of problems are to be found here and there. There are multiple lending organizations in the Thai village, which leads to a debt habit – the farmers borrow money to pay off their debts (consumption ahead of payment). In conversations with the villagers, there is no sense of nervousness with regard to borrowing, and many of the farmers would like the size of the loans to be increased. The situation is quite perilous. Even in Laos, the maximum amount that can be borrowed is set at several times the level of savings, but in Thailand it is usual for the amount to be no more than can be backed up by savings, using either one's own or another member's savings as security. This is because the members borrow from multiple organizations, and the risk of bad debts is high. In Laos, the amount of investment necessary (e.g. to purchase chemical fertilizers) is too great in comparison with the level of savings, so that fixing the maximum amount of loan to the amount of savings deposits would make it difficult to invest in production. For this reason in Laos loans are secured on land and other assets, while the VSGs in Thailand make loans without security7.

The form of the saving group differs in Thai-FIAM and Laos-FIAM. In Thailand the operation costs of FIAM must be provided from the interest from two-step loans. FIAM receives funds twice a year, and so this affects lending by the FIAM Saving Group; loans are made twice a year. In Laos the operation costs of FIAM are held by the aid agencies. Thus FIAM does not need to lend funds to the Saving Groups. This has the result of enhancing the commitment of the villagers to the Saving Group. As far as can be seen from looking at the accounts, the Saving Groups in Laos are operated much more soundly. This is the case even with FIAM; whereas Laos-FIAM produces an Annual Report, in Thailand there is no such material. The existence of Lao Women's Union is decisive.

In Thailand, before the FIAM saving groups can grow, alternative funding is provided. The model for this is the One Million Baht Saving Group, which was established in each village in 2002. At the initial stage the huge sum of one million baht was provided as seed money; this caused villagers to lose their

7 BAAC does not require security for loans up to a certain amount (eg, 3000 baht), but for sums in excess of that a land certificate is needed as security.

commitment to the FIAM saving group (where the loans are small), and saving groups that had been established relatively recently and had small savings deposits are being dissolved. With loans to saving groups as its source of funding, FIAM cannot continue its activities in Thailand under these conditions. The result of this is that FIAM Saving Groups that have not yet grown have been crowded out by the inflow of government capital. The same thing must not be allowed to happen in Laos. It would be advisable to avoid a situation like Cambodia, typically an NGO Mecca, where numberless micro credit programs are in play.

The source of funds for the One Million Baht Bank is an external organization, the government; and so it is formally represented by the Grameen Bank. Some saving, a very small amount, is done. Whereas the CDD and FIAM created saving groups by mobilizing savings, the entry into the villages of the One Million Baht Fund, which does not mobilize savings, is leading to the destruction of the unique financial market that was starting to form after much hard work.

Appendix (I) Regulations of KNSV

Regulation of KNSG 1987, the 4th amendment 2002
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For efficient management of KNSG and to cope with the progress of economic and social situations, the committee has revised the regulation. The general annual meeting on August 3rd 2003 has abrogated the regulation of KNSG 1987, the 3rd amendment 2002 and approved the 4th amendment as follow:

Section 1: This saving group name is "Known noi Saving Group" Tamboon Loom-lum-she, Amphur Ban-kowva, Chaiyapoom Province. It is established on August 12th 1987. The group started to give financial services on September 1st 1987.

Section 2: The objectives of KNSG are:
To raise fund from scattering sources in the area and combine it to help members to invest in their career.
To eliminate poverty by promoting the people to save.
To improve the quality of life of the members and people by encouraging them to invest for production.
To promote the unity of people, help each other and teamwork.
To develop the basic of democracy of population in the area.
To the honor of King Rama the 9th by follow his Majesty the King's Project which has a motto: "Saving to prevent the poverty".

Section 3: There shall be the executive committee that includes the general director committee, auditing department committee, loan department committee, and promotion department committee. The member

shall vote or appoint the committee from the member. The amount of each committee in each department should suitable for their responsibility but all together shall be 9-15 persons. The selection of the Chairman and committee shall follow the regulation shall approved by the general annual meeting. The term of the committees is one year.
The chairman of the executive committee and the chairman of all departments are in the general director committee. The head administrative officer is committee and secretariat.

Section 4: The general director committee selects and appoints the head and the assistance administrative officer that is 2-5 persons. These persons are to perform administration, accounting, secretarial in the office. The practice is under the supervision of the executive committee of KNSG. The reassignment of the head and the assistance administrative officer shall follow the resolution of the meeting of the executive committee of KNSG. The executive committee shall find the temporary office while the group does not have the permanent one.

Section 5: There are 2 kinds of membership.

5.1 Regular member is the one whose house located on Ban Know-noi Moo 4, Ban Pan-din-tong Moo14 and Ban Clong-lo-po, Moo 16, Tambon Loom-lum-she, Amphur Kwau, Chaiyapoom Province. For the person whose house is not in the above area but want to be the member, the executive committee may consider to admit on the case by case basis.

5.2 Irregular member is a person who provides financial fund or carrier group of financial fund in Moo Ban.

The member in 5.1 must be sui juris. If not, the guardian must be agreed with.

The application for the new member is only once on September 1st –3rd of every year. However, the executive committee may consider applications during the year or cancel the new application in some year, but this must be done unanimously.

Section 6: The application fee is 15 baht per person. This amount of money is an expenditure and welfare of the group. If left over money shall be put in a saving deposit at Krung Thai Bank, Chaiyapoom branch or others legal financial institution.

Section 7: The member shall fill every detail in the application form correctly and the committee reserves the right to decide to whom the transferred benefit should go to.

Section 8: Sat-ja saving and Special sat-ja saving shall deposit to the general director committee with in the 1st-3rd of every month at the group office. This money shall be put for time deposit at Krung Thai Bank, Chaiyapoom Branch or others legal financial institution or be used for the group business if that is the resolution of the meeting of executive committee.

The deposit is Sat-ja saving must be in the range between 10-500 baht per month but there is no upper limit and time requirement for Special sat-ja saving. The maximum amount of Sat-ja saving for each regular member is 200,000 Baht.

Section 9: The change of name, last name and address shall notify the general director committee in written with in 7 days.

Section 10: To resign, the member shall report the reason to the general director committee. The committee will consider and inform the resolution of the meeting to the member with in 60 days. If the resignation affects the operation of the group, the committee will withhold the resignation but not more than the end of accounting year.

Section 11: The general director committee shall supervise and follow the performance of officer so that the record of financial is accurate, complete and present. The finical performance shall be investigating every month.

Section 12: All meeting of committees or members shall have recorded minute. The executive committee shall have a meeting at least every 4 months or when appropriate.

Section 13: Every meeting shall accept the majority vote and inform the result to the member.

Section 14: Financial fund of the group comes form:
Application fee.
Sat-ja saving and Special sat-ja form the member.
Income from loan and interest form the Bank.
Fund that is arranged for saving of the group and central fund.
Income from welfare store.
From donation.
Other income.

Section 15: The committee shall meet to decide and then ask the approval from the general annual meeting before take the group's fund to invest. The vote must be greater than 2/3.

Section 16: The member who wants to borrow the money from the group to invest shall save with the group for 12 months and shall be approved in principle by the general annual meeting.

Section 17: The allocation of benefit of KNSG, such as dividend, refund, transfer to central fund, public donation, bonus, material expense, the general management expense and others necessary expense shall be approved by the general annual meeting. This benefit allocation is conducted once a year.

Section 18: The membership status shall be ended when:
Decrease.
Default the deposit of Sat-ja saving for 3 consecutive months without good reasons.
Resign.
Can not follow the regulation of the group.
Being asked to leave by the resolution of the meeting of the executive committee.
Section 19: The activities in details other than the regulation stated above, which are not
conflict with the regulation, the executive committee shall set the operational guideline and propose it yearly to the general annual meeting. The approved guideline shall be a part of this regulation.

Section 20: Only the resolution of the meeting of general annual meeting can amend the regulation.

Section 21: This regulation will be in effect on August 4th 2002.

Appendix (II) Loan form of KNSG

Renew contract	1st time Date……………………………….. 2nd time Date………………………………..

Loan application of KNSG

Contract No. …………/………… Write at KNSG

Date…………Month………………………Year…………………………

To the chairman of KNSG

Name…………………………………Member No………………would like to apply for loan and would like the committee of KNSG to consider as follow

1. I would like to get ◯ a regular ◯emergency ◯ special loan in the amount of….…………฿ (………. …………) The objectives of loan are ……………………………………………………………………………………………...

2. Now I have total savings in the group ……………… ฿ and I save with the group…………… ฿ every month

3. In this loan, I used my members' share to guarantee the loan together with other members witch are

No.	Name, Last name	Member No.	Saving/ Month	Total saving in the group	I agree to be the guarantor for the loan by signing
1.					
2.					
3.					

4. I promise with the group and all members that I will return the principle with the total of………………… times. Each time is ………………… ฿ per month and will pay the interest to the group as promise.

5. If I don't keep my promise as stated in 4., I allow the group to send me to the court and I will pay for any fee and expenditure that occur to the group

Signed……………………………………………..Borrower

Signed…………………….…………………Contract writer

Considered by the loaning Dept. committee

◯ Agree and allow to loan …………………฿

◯ Disagree Reason………………………..

Signed…………………………Chairman of the loaning Dept.

<u>*Approved*</u> Signed………………… ………Chairman of the committee

Signed…………… …………Committee

Signed……………………………Head of KNSG office

I had received…………฿ on the…….. of…………..year…………………….

2. Village Saving Groups in Lao PDR: Factors affecting their Growth

(Case study: FIAM/CODI Saving Group projects in Vientiane Capital/Municipality)

Chansathith CHALEUNSINH

Summary

The government of Lao PDR has recently been attempting to develop a sustainable, market-oriented rural financial system to contribute to poverty reduction and economic growth. Most of the government and non-government organizations are now interested in this kind of financing as a tool for reaching their development objectives. Among the recognized microfinance approaches that have been operated so far, **Village-based saving and credit association,** or the so-called ***Village Saving Group*****,** is a new category of ***outreach type microfinance*** that has been set up in the village level and which has been rapidly evolving compared with other microfinance approaches in the Lao context. In Lao PDR, this type of saving and group-based microfinance has been developed by the Foundation for Integrated Agricultural Management (FIAM) and Community Organizations Development Institute: Thailand (CODI) under the women-oriented development projects.

Because the saving group method has expanded so well, this paper is mainly interested in, and seeks to identify, what the saving groups in Vientiane capital look like and how they work, and to identify the factors affecting the success of Lao-FIAM/CODI saving groups.

This paper can be summarized and will give comments as follows:

<u>*Saving groups in general:*</u>

Saving groups in Laos are generally very strong community-based associations and are a potential saving mobilization approach at the local level.

Because most of the performing funds come from the village, saving groups could be very highly independent in terms of financial resource. This is a sign of building their sustainability.

The saving group committees (management and advisory committees such as the village Lao's Women union, village authority, village party's secretary, youth, guard and senior people) play very important roles in designing the saving and credit products served to the members in the beginning, and skills on loan evaluation before loan approval is given are needed for the committees in order to ensure the financial viability and liquidity of the saving group.

We can say that the existing saving group system does not focus on the poorest of the poor but mobilizes funds from the members (without discrimination) and lends them out to borrowers who need additional funds for smoothing out their businesses. Though, the rate of poverty in Vientiane capital is not so high, but the non-collaterals system (using other guarantees) could be used to guarantee loans for the very poor borrowers.

As a new microfinance approach that works in consistence with Lao people's social and economic conditions, saving groups could not immediately apply as strict financial regulations as the banks to manage the loan delinquency. However, this needs to be considered by the committees who could gradually introduce regulations into the proper system and try to tune them when the saving groups are older and larger.

One subjective task that needs to be done for developing the saving groups is to build the capacity of the villagers on how to manage the saving group. When assistance from the projects is no longer available, there must be some organization that works as a saving group federation to provide technical assistance to the saving groups.

In order to ensure the financial viability of the saving groups as well as the social benefits that the saving group members are intended to get, a certain proportion of the saving money (at least 20%) should be kept in stock every month as a reserve. On the other hand, some orientations on the meaning and the importance of reserve funds, social welfare /life insurance funds and village development funds are needed for the saving group committees so they can understand that it is sometimes necessary to trade-off between the earning from loan interest and non-financial benefits of their members.

Factors affecting the growth of saving groups:

Due to the vital need to expand the saving groups and based on the data analysis, factors that affect the growth of the saving groups have been identified, and the comments to be considered have been given as follows:

1. For the existing saving group's approach, the crucial factor for increasing the participation of the villages in the saving group is to improve the ability of saving group committee members on *how to manage the saving group*, in order to extend the outreach of saving group within the village. Most saving groups have already set internal rules, regulations or by-laws, *but it is necessary to enforce the financial discipline*, especially for penalty measures for overdue loans.
2. In terms of financial benefits (per capita net profit for the members), the saving group's members will be ensured of getting preferable benefits if *most of the population in respective villages is engaging in rice cultivation as a main job* and have other income generation activities as secondary jobs. While the *number of advisory committee's members* plays a very important role

in influencing and screening the members/borrowers, and assisting and auditing the management committee, this is also a potential component which affects the growth of this saving group approach in Lao PDR.

3. At the same time, overdue loan/loan delinquency and Non-Performing Loans (NPL) somehow limit the management capacity of saving groups. From the analysis, *to promote female villagers to participate in saving groups and to require more household assets as collateral* are good ways to reduce the risk of having NPLs. It is also important to avoid *lending money out in Baht currency and setting the frequency of loan repayment* that is more than once a month.

2. Village Saving Groups in Lao PDR: Factors affecting their Growth

(Case study: FIAM/CODI Saving Group projects in Vientiane Capital/Municipality)

Introduction

Recently, while many countries were struggling with the failure to provide small or micro loans to rural and low-income people through the formal banking sector, microfinancing was proving to be a very effective instrument in indirectly alleviating poverty by providing credit at a low cost and reasonable interest rates to small-scale rural entrepreneurs. As a result, most of the Least Developed Countries (LDCs) and developing countries are now seeking for the best practices and approaches in microfinance that will be the most suitable in their countries' context. These countries are also aware that a single or popular microfinance model in one particular area may not work efficiently in a different area and are diversifying microfinance systems in order to find the appropriate model.

Until now, there have been several kinds of microfinance systems studied around the world. Regarding beneficiaries, the saving groups may be divided into two main types; (i) as targeting the poor, and (ii) as outreach type microfinance. Depending on the source of the fund, microfinance organizations can be run ***with seed money (External fund based)*** or ***without seed money (Internal fund based)***. Generally speaking, the Grameen Bank model can be classified as the first type, operating mainly with seed money from the project.[1] The Village Credit and Saving Banks (VCSB) in Phongsaly province in Lao PDR is also considered the first type of saving group[2]. While Village Bank programs in Northeast Thailand[3] are characterized as outreach type saving groups, the groups (village banks) were given external loans by the project in the beginning and will be autonomous after five years or whenever the groups have enough internal funds to lend to their members. One existing microfinance type that targets the poor and which is run with seed money is SIPSACRES[4], a service agency that provides financing to the urban poor, and which started with $30,000 in seed money from UNCDF. An outreach type of microfinancing on the national level is Postal Saving which mobilizes savings from people throughout the country by using the postal network.

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[1] The lending scheme to develop poor women in Bangladesh by providing a loan to a group of five women and collecting social collateral in the form of group guarantees. The operating fund was provided by Grameen Bank.

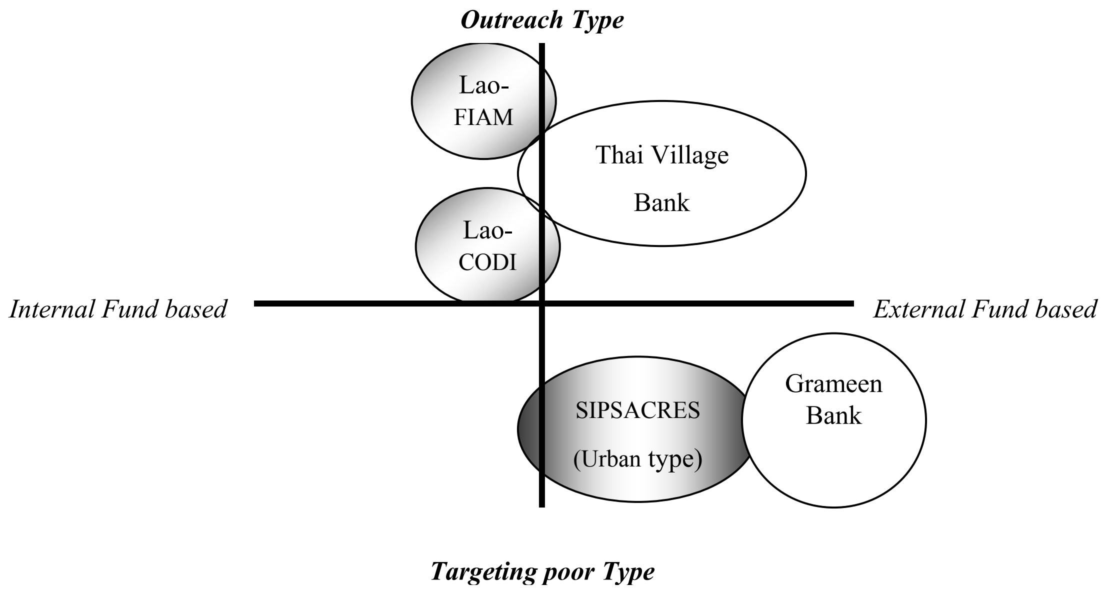
[2] The credit scheme under PDDP -- a comprehensive development project in Phongsaly province which focuses on improving the living standard of the poor in the mountainous and rural areas. The project contributes 7 times the village's fund (people's contribution).

[3] Please refer to Microfinance in Northeast Thailand: Who benefits and How much? Written by Brett E. Coleman, (Mekong Department, ADB), April 2002.

[4] Sihom Saving and Credit Scheme: SIPSACRES was developed from Sihom Rehabilitation Project and used to be under UNCDF microfinance project (1995 to 2002). It is now under the supervision of Finance department, Vientiane Capital. SIPSACRES provides credit and saving service to the urban poor.

However, a new category of outreach type microfinance, or “village based saving group,” has been set up in villages and has surprisingly grown and expanded without depending on seed money. Especially in Lao PDR, this type of saving and group-based microfinance has been instituted by the Foundation for Integrated Agricultural Management (FIAM) and Community Organizations Development Institute: Thailand (CODI) under women-oriented development projects. The different sources of funds and its beneficiaries of microfinance are illustrated in Figure 1.

Figure 1: Types of Microfinance, classified by sources of funds and its beneficiaries

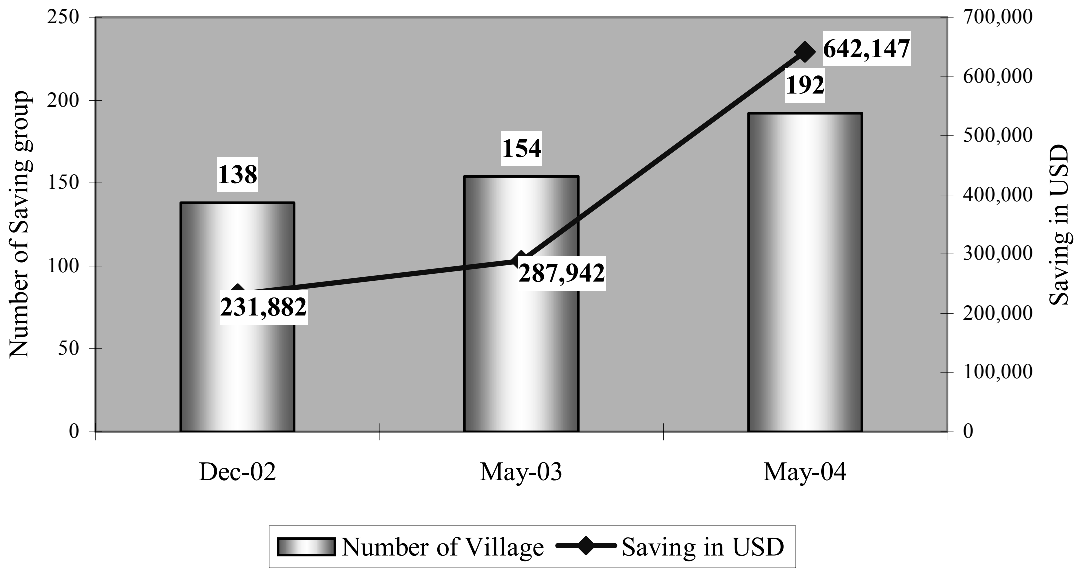


In order to provide information on this new type of outreach microfinance, this paper is mainly interested in, and will seek to identify, the factors affecting the success of Lao-FIAM/CODI saving groups. Further studies will then be conducted on other outreach types like SIPSACRES or Postal saving.

Chapter 1: Saving Groups in Lao PDR

As in many countries, the government of Lao PDR is attempting to develop a sustainable, market-oriented rural financial system to contribute to poverty reduction and economic growth. Most of the government and non-government organizations are now interested in this kind of financing as a tool for reaching their development objectives. Among the recognized microfinance approaches[5] that have been operated so far, **Village-based saving and credit association**, or the ***Village Saving Groups*** have shown potential and have rapidly evolved compared with other approaches in the Lao contexts.

Figure 2: Growth of Village Saving Groups in Vientiane Capital



Source: Integrated Report of Saving group activity, May December 2002, May 2003 and May 2004, FIAM &CODI

The *Village saving group* is a group of people who share the same voluntary spirit to help each other in solving problems on financial liquidity in order to improve solidarity and upgrade the living standard of people within the village. Basically, the saving group is an association which accumulates savings of the group's members[6] and loans them to members who need to borrow them and charging them a loan interest rate which must be higher than the savings' rate of return. In addition, some strong saving groups also provide member support services, such as vocational training and establishing production group based on the potential of their members.

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[5] These include approaches of *Formal Sector* such as Agriculture Promotion Bank (APB) and Lao Development Bank (LDB), and approaches of *Semi-Formal Sector* such as Former Microfinance Project (MFP), Cooperative de Credit de Soutien aux Producteurs (CCSP), Projet de Development Rural du District de Phongsaly (PPDP), Rural Development Cooperative, Credit Union Pilot Project and other illustrative INGO Initiatives

[6] That must be equal to or higher than the minimum savings the group has established.

Due to the poor monitoring of microfinance activities in Laos, the exact figure on saving groups is not available in much detail. However, based on the official report from LWU projects supported by FIAM and CODI in May 2004, there are approximately 231 saving groups run and lead by village women in Vientiane province, Khammuane province, and in Vientiane capital. These groups serve a total of 23,080 members and can mobilize saving about 7,136,484,200 kip from members. The proportion of village saving groups to the total number of villages in the province is relatively high with 64% coverage in Vientiane Capital, 14% in Vientiane province and 8% in Khammuane.

Table 1: Village saving groups running under LWU projects (in collaboration with FIAM and CODI), as of May 2004

				May-04				
Province		**District**	**Total village**	**Village Saving group**	**Coverage**	**Member**	**Saving in Kip**	**Saving in USD**
VTN cap	1	Xaythany	103	95	92%	11,484	5,105,951,000	$486,281
	2	Xaysetha	52	4	8%	499	13,533,000	$1,289
	3	Naxaythong	56	23	41%	2,237	30,300,200	$2,886
	4	PakNgum	53	53	100%	4,304	1,373,206,500	$130,782
	5	Sangthong	37	17	46%	1,253	219,553,500	$20,910
			301	***192***	***64%***	***19,777***	***6,742,544,200***	***$642,147***
VTN prov.	6	Thoulakhom	74	6	8%	755	122,598,000	$11,676
	7	Viengkham	18	7	39%	597	32,291,000	$3,075
			92	***13***	***14%***	***1,352***	***154,889,000***	***$14,751***
Khammuane	8	Thakhek	141	24	17%	1,870	207,214,000	$19,735
	9	Hinboune	166	2	1%	81	31,837,000	$3,032
			307	***26***	***8%***	***1,951***	***239,051,000***	***$22,767***
		Total	**700**	**231**	**33%**	**23,080**	**7,136,484,200**	**$679,665**

$1=10,500 kip

Source: FIAM and CODI monitoring sheet, May 2004

The application of saving groups in Lao PDR seems to be feasible for many reasons. For example, the saving groups operate in accordance with the government's policy to promote the village unit as an implementer of development plans; strong saving group committees can increase people's confidence in joining saving groups. As there is much discussion about principles, members of saving groups are gradually trained in how to manage their money, and the saving groups also play a very important role in building up the solidarity among the villagers by accumulating individual savings and disbursing them to members as loans. Furthermore, saving groups allow people to access small loans at reasonable interest rates in a simple procedure which is easier and more comfortable for the villagers and which reduces the number of high interest rate loans borrowed from moneylenders. Due to the simple monitoring system of the saving groups, the committees can manage them (book keeping, saving and credit record, etc.) in more efficient ways. In addition, saving groups can mobilize money from the locals and reinvest it in the local economy, which can gradually help to develop a particular area.

Chapter 2: Data

2.1 Data collection

"Saving group" operation in Lao PDR, especially in Vientiane Capital, is quite different from the "Village Bank" system in Northeast Thailand, due to the fact that most of the village saving groups in Laos are currently based on money mobilized within their villages or internal funds rather than from soft loans from a project. However, this approach was promoted by the Thai NGOs, Foundation for Integrated Agricultural Management: FIAM, and Community Organizations Development Institute: Thailand or CODI, starting in 1997. Both organizations follow the "Village Bank" group lending methodology of the Foundation for International Community Assistance (see FINCA 1990 and Hatch 1989).

Based on the postal survey[7] conducted by the Microfinance Capacity Building and Research Project (MCBR), there are 357 saving groups being monitored by seven government agencies[8]. Among the 17 provinces and one special zone, there are a significant number of saving groups in Vientiane municipality. Most of the groups in Vientiane are running under the technical support of two main bilateral projects, "Small Rural Development Project for Women" and "Capacity Building Project for Women and Community," between the Central Lao Women's Union, FIAM and CODI.

The committees of 103 randomly selected village saving groups within 5 districts in Vientiane municipality under FIAM and CODI projects, were surveyed in 2 different periods. The first survey was conducted from 2nd-12th August 2004 to collect data from 39 selected village saving groups. The team went to every village by car and interviewed the committees in each village by using the interview guide, and also looked at their records and accounting books to confirm their answers. The second survey was conducted from 6th-14th October 2004, but due to limited time, the team could not collect data by visiting each village. Using the new survey approach, data from 64 village saving groups were collected through the following 2 steps: (i) sending a questionnaire in advance to the committees in each selected village, and inviting them for a one-day meeting in the district office, and, (ii) in each district's meeting the village committees brought their completed questionnaires, monitoring sheets, books and records, and the members were interviewed again by the survey team to confirm the information. Table 2 shows that the sample represents 54% of total saving groups in two projects' sites.

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[7] Postal survey on small saving and credit activity in Lao PDR, conducted from September to October 2003 by sending questionnaire to seven government agencies.

[8] Seven agencies: District Lao Women's Union, District Lao Youth's Union, District Planning Office, District Social Welfare Office, District Finance Office, District Agriculture and Forestry Office and branches of Agriculture Promotion Bank.

Table 2: Sample of the Survey in Vientiane capital

	District	Total Village saving groups	Selected VSG	Percentage
1	Xaythany	95	48	51%
2	Xaysetha	4	1	25%
3	Naxaythong	23	15	65%
4	PakNgum	53	30	57%
5	Santhong	17	9	53%
	Total	**192**	**103**	**54%**

Source: FIAM and CODI monitoring sheet, May 2004

2.2 Description of Data: Findings

Due to the increased demand of loans from the members to invest in their income generating activities and their living conditions, the survey found that 96%-98% of the sample said that the social and economic situations in their villages have improved, especially solidarity, which had improved through increased familiarity among the villagers. In addition, borrowing from moneylenders within their villages had decrease, and the selling of Green Rice[9] among the farming villages also decreased.

2.2.1 Member and Non-member

In relation to the proportion of saving group members to the total population in each village, the participation ratio in all sample villages is less than 50% in total, which means that more than half of the people in the village did not join the saving group[10]. Conversely, when we asked the question: How many households registered to be saving group's member?, we found that in 43 villages (46% of total sample), more than 50% of total households participated in saving groups. This means that there is at least one person per household within those villages (*please see details in table 3*).

Table 3: Participation Percentage of Saving Group in each Village

	Participation by member		**Participation by member-Household**	
	No of sample	Percentage	No of sample	Percentage
Equal or less than 50%	103	**100%**	50	54%
More than 50%	0	0	43	**46%**
Total	103	100%	93	100%

Source: NERI's saving group survey, August and October 2004

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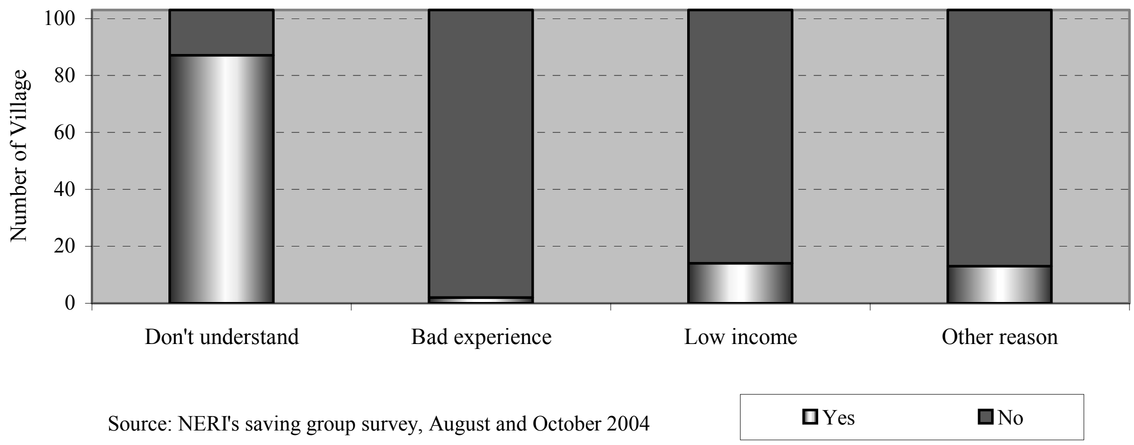
[9] Green rice selling or Khai Khao Khiew means farmers sell rice at a discounted price, which is evaluated by the middleman or the traders, before it is harvested. The traders/middle men then come to take the rice after it is harvested.

[10] Young people under 18 years old (both male and female) are not allowed to borrow money, but can save their money with the group and get annual benefits

Because saving group programs are operated through the Lao Women's Union network from the central to the village level, most villages with saving groups limit their services just to the village[11], but are open to all villagers without discrimination of age, sex or social class. However, most of the saving group members (more than 50%) in 101 villages (98.1% of the sample villages) are women.

In regards to the outreach figure presented at the beginning, there is still some percentage of individuals who remain being non-members. We found that the main reasons that people do not join the saving groups are, firstly, they do not understand the objectives and benefits of the saving groups very well. Secondly, they have low incomes and cannot often or continuously save their money, and thirdly, villagers don't join because of bad experiences, especially the collapse of credit cooperatives in the past, combined with corruption of some saving group committees (*please see figure 3*). Because of these factors, the remaining people are not ready or willing to be saving group members.

Figure 3: Reasons for being Non-members



Source: NERI's saving group survey, August and October 2004

2.2.2 Administration and Working System

The survey also found that most of the saving groups have been established with the cooperation of the village mass organizations such as village Lao Women's Union (VLWU), village Youth Union, village guard/security and Lao Front for Construction. In addition, the village party's secretary and village authority (village head or deputy village head) closely supervise the saving group. A representative from each agency and authority is selected and assigned to be a member of the saving group advisory committees. The VLWU members are mostly selected to be on the management committees. This participation may be one of several factors creating credibility of saving groups for the villagers.

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[11] This is easy to manage and the committees know the socio-economic backgrounds of the members better than people who are living outside

Generally, the management and advisory committee[12] members work at the voluntary level, and agree on and designate 1-4 particular days[13] per month to this work. In the first two days, the saving group members must pay all "inflow" money (saving money, loan principal, loan interest, registration and other fees) to the MC in a particular place, for example temple or village authority office[14]. After collecting all the money for the month, both committees hold an internal meeting to consider and approve the loan application forms[15] at the end of the first or second day, then disburse the loans on the third or fourth day.

In the last month of the year, the saving group will close all account books and calculate the total revenue and expenditures to determine the net profit and distribute the money to all stakeholders. Distributions are generally based on the following average percentages of net profit.

Table 4: Distribution of saving group's Net Profit

Stakeholders	Average % of net profit
Members	70%
Management Committee	14%
Advisory Committee	4%
Social welfare fund	2%
Reserve fund	6%
Village Development fund	3%
Network committee	1%
Total	**100%**

Source: NERI's saving group survey, August and October 2004

Of the village saving group committees interviewed, 75% said that they faced problems operating the saving groups. The main problem is that people do not understand what saving groups are, especially the objectives, benefits and how they work. Secondly, there are technical problems, particularly in accounting, which shows that some committees still rely on the project field staff to do their accounting every month. The third problem is that they don't have sufficient funds to supply their clients' demand. However, regarding the problems they have faced and the positive changes they have had, about 94.2% of the sample villages have made a future development plan of increasing the number of clients, establishing

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[12] ***Management committee*** (MC) is composed mainly of 5-7 village women/VLWU, and is responsible for all management duties including bookkeeping, recording, encouraging and so on. The ***advisory committee*** is composed of 2-5 senior or respected people and other mass organizations within the village. This committee's role is to give advice to the management committee, solve problems and join the MC to consider and approve loans.

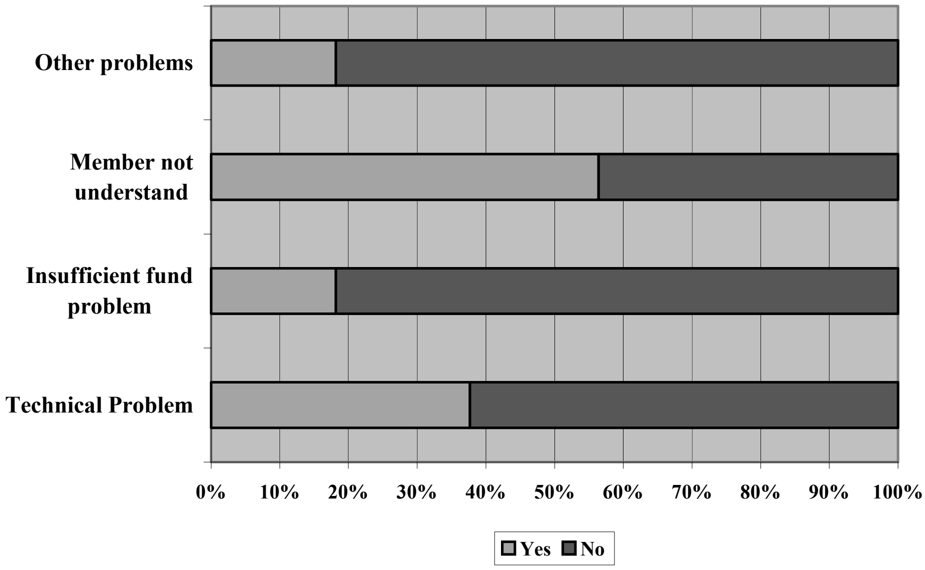
[13] This depends on the number of members and the condition of the village (whether the villagers are available). It is decided in a democratic manner among all members.

[14] In order to minimize the operational cost, most saving groups have no permanent office.

[15] Only 5.8% of the 103 samples use informal systems for applying the loan (by words of honor submission to the MC)

new services for members, especially for social welfare or life insurance, and improving their working system, especially in accounting.

Figure 4: Problems of the saving group



2.2.3 Saving, Credit and other Services

2.2.3.a. Saving

The saving groups work mainly to mobilize villagers' savings and build up the village development fund, which grows by lending out money to generate the group's income. The villagers who want to be members of saving groups need to apply with the MC and pay a registration fee of 1,000 to 3,000 kip (this includes pass book cost and membership fee).

The members must deposit their money every month -- a compulsory saving that should not be lower than the minimum saving, which varies from 2,000-10,000 kip per month[16]. On the other hand, there is no maximum amount or limit to the amount that can be *saved* per month, as most villagers (62.1% of the sample) do not base the amount of money they save on the size of the loan. In other words, a loan is not dependent on how much a member saves, but the total amount of the fund collected in that particular month, the collateral to guarantee the loan, and the capability of the borrower to pay back the loan. Furthermore, the survey found that 70.9% of the sample does not put a ceiling on the *loan* size.

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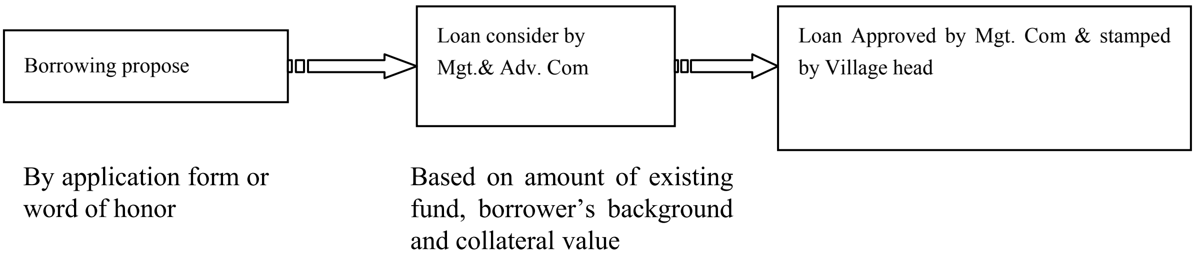
[16] Some village saving groups have changed the minimum amount of money to save after running for a period of time, in order to make it suitable to their villages.

2.2.3.b. Credit

Based on the income-generation activities of the villagers, there are different types of loans, such as agricultural loans, commercial loans, and emergency loans, which vary according to the loan purpose, interest rates, terms and conditions. Some particular village may set a 3% interest rate for an agricultural loan and allow the borrowers to repay the loan in 6 months, while a commercial loan may be charged at a 5% interest rate and required to be paid back within only 3 months. According to the saving group's survey, the loan interest rate is from 3% to 5% per month and the term of loan varies from 3 to 6 months.

Based on the saving group's by-laws, the member who intends to borrow money needs to submit their loan application form and pay an application fee which varies from 1,000 to 7,000 kip. In some villages, the low-income people are not required to submit the loan application form but words of mount submission without any fee.

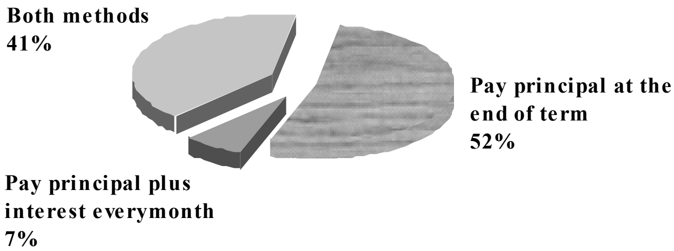
Figure 5: Loan application and approval procedure



Source: NERI's saving group survey, August and October 2004

In regards to repayment, the borrowers have many options for repaying a loan and its interest: (i) pay interest every month and pay principal at the end of the period, (ii) pay principal plus interest every month and (iii) mix both systems. Most of the informants (the sample) answered that their clients like to use the first and third system (about 52% and 41% of the sample respectively) rather than the second one. It is evident that there is no exact rule to repaying the loan principal and interest; it is mainly based on the willingness and ability of the borrowers. (*Please see figure 5*)

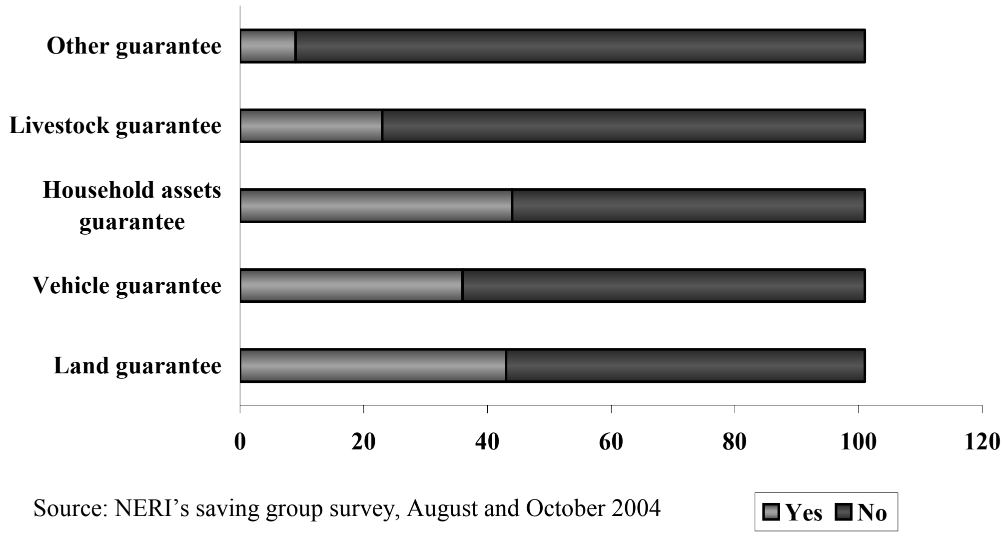
Figure 6: Repayment Method



Source: NERI's saving group survey, August and October 2004

Since the village (as a big group of people), has been selected to be a unit for saving groups, collateral, rather than having a group guarantee (only 5.8% of the sample uses the small group guarantee method) is frequently used to guarantee loans. In terms of collateral, household assets including televisions, refrigerators, washing machines and so on are mostly used. The next most common type of collateral is land; the third is vehicles and fourth is livestock. However, nearly 95.1% of the sample responded that they never confiscate these assets from their clients.

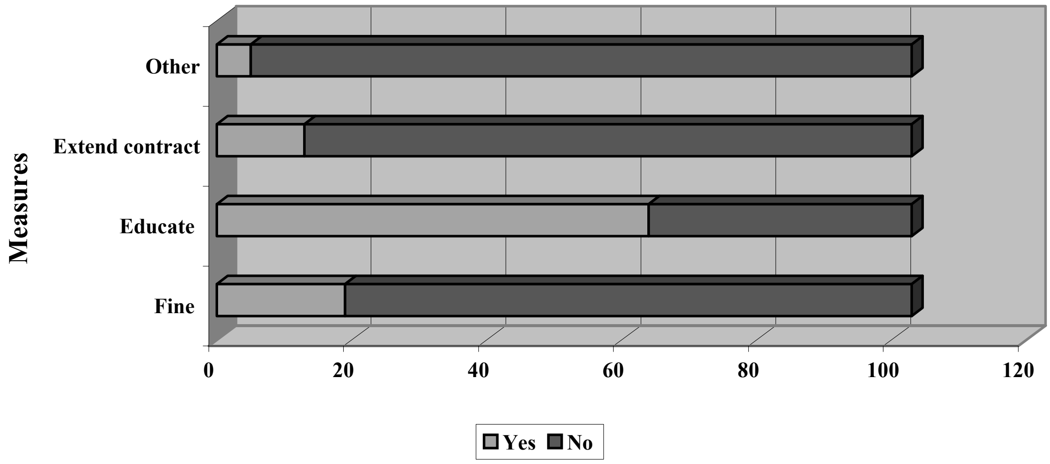
Figure 7: Loan collateral



Source: NERI's saving group survey, August and October 2004

Even the saving groups operate under the democratic system and the satisfaction of its members to define the internal regulations or by-laws. But the borrowers of 70.9% of the village samples cannot follow the rules they have set, particularly paying back the loan on time. In this case, only 18.4% of the sample villages employ measures to collect overdue loans, and 12.6% allow the borrowers to extend the loan contract. Most of the sample villages (about 62.1%) seem to educate borrowers rather than apply other measures. As a result, 88.3% of them said that there are no NPL (non-performing loan) within their groups.

Figure 8: Measures used for collecting overdue loans



Source: NERI's saving group survey, August and October 2004

2.2.3.c. Other Service

Apart from saving and credit, some strong village saving groups (in terms of financial resource and management system) (about 35% of the sample) reported that they also provide other financial services, such as life insurance or social welfare for members, which are supported by an additional fee collected from the members in combination with the annual distribution (dividend from the net profit).

2.2.4 Internal and External Monetary System

Initially, village saving groups' funds are built up from individual savings, and loans are generally disbursed to the borrower in the first month that they collect the money. In addition to technical assistance provided by supporting agencies, projects, especially CODI, partly provide soft loans to some infant or small saving groups as *seed money*[17] to supply their borrowers' demand. FIAM is now trying to solve this problem by encouraging and pairing off the "Surplus-demand saving group" with the "Excess-demand saving group" instead of providing loans from the project[18].

On the other hand, even though most of the saving group's transactions are done outside the bank, some saving groups open deposit accounts in the formal banks upon the project's suggestion. For example, 46 saving groups (44.7% of the sample) have opened deposit accounts in the state-owned commercial banks such as APB (Agriculture Promotion Bank) and LDB (Lao Development Bank), as a requirement from the project for transferring money in terms of loans or other purposes. However, saving groups do not deposit their group's money into the bank as often.

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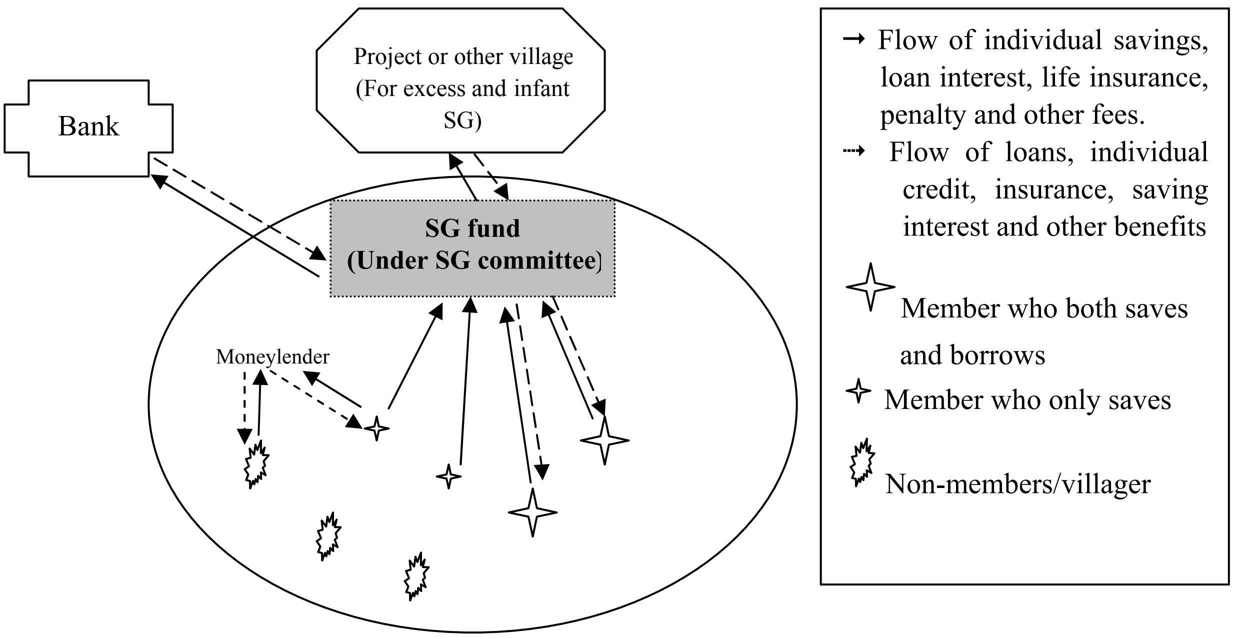
[17] This is used in case a saving group, or "Excess demand saving group", has a very small fund and cannot meet the members' borrowing demand.

[18]In regards to this, only 18% of 77 problem-facing villages answer that they face the problem of insufficient funds.

Figure 9: Money Circulation of Saving Group



Source: NERI's saving group survey, August and October 2004

In terms of currency used in the saving groups, we found that Kip has been accepted as the official currency for both saving and credit transaction. Nevertheless, about 2.9% of the sample saving group accepts US dollars and 15-18% of the sample accepts Thai Baht from the members and disburses that currency to the borrowers at the same exchange rate.

Along with the saving groups, almost half of the total selected sample villages (40.8%) still have moneylenders who loan out money within the village. This supplier plays an important role for both saving group members and non-members when they need to get a large loan in a short amount of time – demands that saving groups cannot always meet.

2.3 Saving Group Analysis based on the Findings

Based on findings from the survey, the following main issues have been determined:

1. Utilizing mass organizations, especially the strong and country-wide network organizations like LWU[19], has a certain advantage for the saving group model in Lao PDR because they are community-based and can effectively target the poor. This might be a key in helping saving groups operate and grow more rapidly, and may be, in this sense, stronger than saving groups in

[19] LWU was founded in 1955, and there are district, provincial and national levels of the LWU. LWU operates in every village in the Lao PDR and is active in a significant share of INGO projects as an intermediary, an organizer, and as the Lao Government counterpart. Because of its reaching into the village, LWU has frequently been the implementing agent or partner for INGO-supported projects.

Thailand (Surin and Roi-Et) who are even assigning and focusing the tasks to women in the villages.

2. The saving group is quite accessible to everyone in the villages because it does not set strict eligibility criteria for the members. People who permanently live in the village have the right to be saving group members at a very low entry cost. People in high or middle income brackets can deposit/invest their money into the group to gain higher benefits than the bank, which can be good for mobilizing saving money and lending it out to the poorer. Conversely, the Grameen Bank in Bangladesh depends totally on external funds with the purpose of distributing loans to the poor, and households owning assets valued at more than a certain amount are, in principle, excluded from participating in the microfinance program.

3. The studied saving groups do not use peer groups or saving money to guarantee loans as in other microfinance schemes e.g. VCSB in Phongsaly or SIPSACRES, but collateral which is equal in value to the loan amount. From this, it should be kept in mind that most of the saving group members are not the poorest of the poor, but low-income people who have at least some items to guarantee their small loan. With a few exceptions, saving groups allow the poorest people within the village to get the loan by relying on a respected person, group of people or their saving money in the passbook to guarantee the loan.

4. Most of the saving groups do not set a maximum amount for savings and loans, which is different from other financial organizations. In the author's point of view, it is understood that *not setting a maximum saving* amount is good for mobilizing the local funds. However, because the saving groups' operations mainly depend on the saving money, there might be a financial shortage problem when the big savers withdraw all their money. On the other hand, *not setting a maximum loan* amount, or loan ceiling, would not cause any problems as long as the committees consider and approve the loan fairly based on the existing fund, borrowers' capacity to pay, and giving equal priority to every member to borrow (this needs to be studied in-depth in the future).

5. The figure from the survey shows that only 10.8% of the studied villages have had Non-performing Loan (NPL). On the other hand, 71.6% of them said that they have overdue loans. There are two possible reasons for this situation: (i) the term of loan does not match the income earning period or occupation of the borrowers, so the members could not pay back the loan on time, or (ii) there is no enforcement on paying back overdue loans or the measures are not working. In the second point, we can clearly see that even though some saving groups have set penalty measures for overdue borrowers, most saving groups choose to educate rather than fine those borrowers, and extend the loan contract (if the reason for paying late is acceptable). However, this might be a new strategy for solving loan payback delinquency in the Lao context.

6. With the local-based development strategy of FIAM and CODI, the vast proportion of support is technical assistance in aiming to build the capacity of local committees and volunteers in order to ensure good performances in the long run. This strategy is unlike other microfinance projects, which assign people outside the village to implement all activities (as the field workers) and they might be disappear when the projects are ended, thus jeopardizing any chance for sustainability. However, to build the capacity of the villagers who lack knowledge and experience on how to systematically manage saving groups requires time and a large budget. Looking at the discrepancy between the needs of the groups and the limited resources of the project, very small numbers of committees have attended the training course held by the project[20] and therefore still rely on the project's staff and district committees to help them close the monthly and annual accounts.

7. Regarding the distribution of annual profit, village public funds were built up with different purposes such as for social welfare, reserve, and village development. Those funds should normally be utilized according to their mandates, however, a shocking 80% of the surveyed village saving groups that have social welfare, life insurance and reserve funds said that they usually lend these funds out to gain more income. Therefore, the social benefits that members expected to get from these funds (when they were in desperate situations) would be replaced by revenue from the loans. So, the question is "What makes those funds different from saving money?" If all money within the saving group is used for lending, this issue also needs to be studied more.

[20] Only 33% of committees in sample have a chance to attend the training course on how to manage the saving group more than once a year.

Chapter 3: Factors affecting The Growth of Saving Groups

Regarding the positive impacts of saving groups on people's living conditions and its existing high growth, this paper seeks to identify some indicators that represent the performance of the saving groups and to use the collected data to find the main factors that negatively or positively affect those indicators.

The expected proxies will be the general functions of saving groups, which can measure the degree of a group's performance in a particular area in comparison with other saving groups.

After processing and considering causes-effects and looking at available data, three main indicators have been identified and presented below.

3.1 Participation Ratio (Outreach): Function (A)

The *Participation Ratio* of a saving group is an indicator that can measure the coverage of the saving group's services within a village[21]. Three main significant factors/variables that influence this indicator are:

(A1): Number of women in the village (-)

Due to the limited capacity of saving group committees in management, when the population in a village, especially of women, increased[22], the saving group committees could not increase their capacity in screening, monitoring and attracting more members. Thus, the percentage of saving group household members in that village will be comparatively decreased.

The function for Participation Ratio is:

Participation ratio= Number of Member Household/ Total village Household

(A2): Introduction of Penalty Measures for Overdue Loans (+)

In general, in order to maintain the sustainability of the organization, financial discipline is needed to manage saving groups especially for the borrowers who do not pay back the loan on time. In terms of coverage, when the committee applies penalty measures (such as fees, which would go to the income of the saving group) for overdue loans, people do not want to pay late. This pressure drives the group to have as many funds as they expected to get in the month, therefore increasing monetary circulation, and making the borrowers happier. This has an indirect effect on increasing the credibility of the saving group committee and increasing the number of members at the same time.

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[21] To run this we use *the percentage of total saving group members in households to total village households* as a function.

[22] We found that more than 50% of members in 101 saving groups (98.1% of total selected villages) were women.

(A3): Time period of running saving group (+)

Normally, time may be one considerable measure in every sense and can also measure the outreach of a saving group. When the saving groups have operated for a long time, the committees will gain more experiences and techniques in running this kind of service and the villagers will gradually know what benefits they can get from being saving group's members. Therefore, the longer running saving groups will have a higher participation ratio.

The general function for Participation Ratio is:

Function (A):	**0.52**	**- 0.0002 A1**	**+ 0.13 A2**	**+ 0.002 A3**
T-Value	(9.98)	(-4.02)	(2.54)	(2.45)
P-Value	(.000)	(.000)	(.013)	(.016)
R^2	.272			
F	11.106			

3.2 Per capita net profit: Function (B)

Per capita net profit or "dividend per member" is the annual profit that every member would receive. This has been calculated from the 70% (from Table 4) that members would receive as seen in the following formula:

Per Capita Net profit = [(Total Revenue-Total Expenditure)*0.7] / Total members

This indicator is mainly dependent on how long saving groups have been running, members' occupations, and the number of advisory committees. The variables and function are explained below.

(B1) Time period of running saving group (+)

In regards to the fund's accumulation, the longer running saving group would have a bigger fund as a result of loan interest benefits and other fees. Therefore, the bigger fund will provide more benefits, then the net profit per members will be increased as per the number of years running.

(B2) Number of people who engage in rice cultivation as a main job (Farmer) (+)

The number of farmers within the village has a positive effect on the profit of the saving group as a whole, as well as the profit per capita. Because farming is the main occupation in most of the selected villages, with the saving group, the farmers can have enough rice for their daily consumption and may sell the rest for a profit (in case the production is higher than their consumption). Not only that, but the farmers are also conducting non-farm and off-farm activities such as trading, employing, services, and handicrafts which can provide them with additional income. As farmers are potential members, when the number of farmers within the village increases, the number of farmer members will increase, and the transactions within the group will be more active which will lead to a rise in annual profit.

(B3) Number of advisory committee's member (+)

Regarding the administrative system in Lao PDR, every village saving group usually includes members of village authority, village mass organizations and respected individuals who are the members of the saving group advisory committee. This committee is in charge of consulting the management committees in credit consideration and plays a very important role in promoting, encouraging and building the credibility of saving groups. Therefore, a large number of advisory committee members will increase the efficiency of the saving group shown in the form of per capita net profit.

The function that explains the relation between per capita net profit and the above three variables is as follows:

Function (B):	**-273.60**	**+1.36 B1**	**+ 246.76 B2**	**+ 5.73 B3**
T-Value	(-8.89)	(5.65)	(8.85)	(1.71)
P-Value	(.000)	(.000)	(.000)	(.092)
R^2	.662			
F	43.74			

3.3 NPL (Non-Performing Loan): Function (C)

Apart from indicators that measure the achievement of the saving groups, the existence of non-performing loans is also one indicator that measures the efficiency and financial liquidity of the saving group. Following is the function and its explanation.

(C1) Proportion of women within the village (-)

The increasing number of women within the village will lead to increased participation of women in the village saving group. As microfinance has been proved important in empowering[23] women to enhance their perception in generating household income and family welfare, to increase their responsibility and participation in deciding on household expenditures and other issues, we can say that women are the main target and qualified members of saving groups. Therefore, to increase the number of female members in the saving group can reduce the risk of debt or having a NPL.

(C2) To Require the Household Asset as loan Collateral (-)

The potential of saving groups is to adapt itself to people's living conditions. In terms of loan collateral, apart from valuable property like land and a house, household assets are usually used to guarantee the loan. As the value of the assets is not very high but rather, equivalent to the loan size, and as the assets are used daily, they don't want to lose it. Thus, to require household assets as a guarantee of the loan is a way to reduce NPLs.

[23] Mayoux L, 1997, "The Magic ingredient? Microfinance and Women's Empowerment", GCAP Briefing Paper for the Microfinance Summit.

(C3) To lend money out in terms of Baht Currency (+)

Based on the frequent fluctuation of currency, lending money out in terms of Baht will probably create some problems for the committee in getting repaid in the same currency. If at payback time, the cost for buying that currency is high or the borrower cannot get enough currency for paying back, the saving group will risk having a NLP.

(C4) The frequency of monthly loan installment (+)

In general, the saving groups have determined the borrowers to pay an installment once a month is the appropriate frequency the loan repayment. If the frequency for repaying the loan in a month is increased (more than once a month), the borrowers may not be able to pay back the loan on time, and this will lead to loan delinquency.

Function (C):	**0.65**	**- 1.69 C1**	**- 0.12 C2**	**+ 0.23 C3**	**+ 0.29 C4**
T-Value	(1.76)	(-2.33)	(-2.03)	(2.96)	(3.07)
P-Value	(.082)	(.022)	(.046)	(.004)	(.003)
R^2	.249				
F	7.77				

Within the above three functions, we will not include "Time of running" into our consideration as a factor affecting the growth of saving groups, because it is quite normal and we could not change it in order to improve the performance or growth of saving groups.

Chapter 4: Conclusion

General Views of Saving Groups

1. *To have strong community-based associations is one potential of saving groups in Lao PDR.*

2. *Because most of the funds comes from the village, saving groups can be highly independent in terms of financial resources; this is a sign of building sustainability (please see ANNEX).*

3. *We may say that the existing saving group system does not focus on the poorest of the poor but mobilizes funds from the members (without discrimination) and lends it to the borrowers who need additional funds for smoothing out their businesses. The rate of poverty in Vientiane capital is not so high, however, non-collateral (other guarantees), could be used to guarantee the loan in case the borrowers are very poor.*

4. *The saving group committees (management and advisory committees) play a very important role in designing the saving and credit products served to the members in the beginning, and skills on loan evaluation before approval are needed for the committees in order to ensure the financial viability and liquidity of the saving group.*

5. *As a new microfinance approach that works in consistence with Lao people's social and economic conditions, saving groups could not immediately apply as strict financial regulations as the banks to manage the loan delinquency. However, this needs to be considered by the committees who could gradually introduce regulations into the proper system and try to tune them when the saving groups are older and larger.*

6. *One subjective task that needs to be done for developing the saving groups is to build the capacity of the villagers to manage the saving group. When assistance from projects is no longer available, there must be some organization that works as a saving group federation to provide technical assistance to the saving groups.*

7. *In order to ensure the financial viability of the saving group as well as the social benefits that the saving group's members are intended to get, a certain proportion of the saving money (at least 20%) should be kept in stock every month as a reserve. On the other hand, orientations on the meaning and the importance of reserve funds, social welfare /life insurance funds and village development funds are needed for the saving group committees so they can understand that it is sometimes necessary to trade-off between the earning from loan interest and non-financial benefits of the members.*

The Factors Affecting the Growth of the Saving Group

Based on the *Analyzing the Impact and the Services of the Saving Group* studied by other Lao members of financial working groups under MAPSII project[24], "The Saving Group has to play an important role to increase saving and borrowing to improve livelihood and raise income of members. Therefore, it is vital to expand the Saving Group in rural poor areas". Thus, following are the factors affecting the growth of the saving group which need to be considered.

1. For the existing saving group's approach, the crucial factor for increasing the participation of the villages in the saving group is improving the ability of saving group committee's members to manage the saving group, in order to extend the outreach of the group within the village. Although most saving groups have already set internal rules, regulations or by-laws, but it is necessary to enforce the financial discipline, especially for the penalty measures for overdue loans.

2. In terms of financial benefits (per capita net profit for the members), the saving group's members will be ensured of getting preferable benefits if most of the population in respective villages is engaging in rice cultivation as a main job and have other income generation activities as secondary jobs. While the number of advisory committee members plays a very important role in influencing and screening the members/borrowers, and assisting and auditing the management committee, this is a potential component which affects the growth of this saving group approach in Lao PDR.

3. At the same time, overdue loan/loan delinquency and NPLs somehow limit the management capacity of saving groups. From the analysis, to promote female villagers participating in saving groups and to require more household assets as collateral are good ways to reduce the risk of facing NPLs. It is also important to avoid lending out money in Baht currency and setting the frequency of loan repayment that is more than once a month.

[24] The survey was lead by Phouphet KYOPHILAVONG, Deputy head of Economic Department, Faculty of Economics and Management, National University of Laos.

Annex

Future Prospects for the Excess- demand and Surplus-demand Saving Groups

As there is usually no limit for saving and loan, some villages don't have enough money to lend out and some villages have a surplus of money within a particular month. The saving groups that have excess demand have to average the existing money to their borrowers; some postpone the loan or borrow from the project or from other surplus villages. But most of the surplus villages usually keep their surplus money in stock, and just a small number are keeping their money in the bank or lending it to other excess villages.

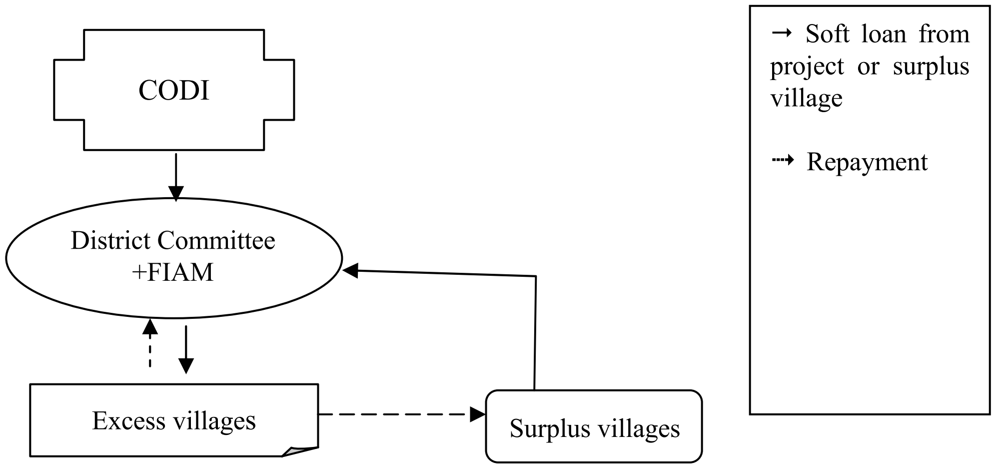
The main reason for excess demand is that there is very high demand in the production period especially during the rice planting season. The school season is also creating a demand for loans. In the other times of year, there is an excess supply in the saving groups. Not only that, but the accounting system also affects the need for borrowing money, as people like to borrow money in the beginning of the accounting year or after the division of the benefits because they have plenty of time to pay it back before the account is closed. In the 2-3 months before closing the account, only a few borrowers take out a loan because they have to pay it back in a short period of time (before the division of benefits).

Figure 10: Demand of loan in a financial year

Operating Month	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th	11th	12th
	High demand for loan									Stock the money (most of money is kept in the stock)		Close the accounts and distribute the dividend

As a result, CODI project tries to encourage the district saving group committees to lend soft loans to the excess villages, while FIAM tries to promote their saving groups in their project's scope to create friendships with each other, especially for the surplus and excess villages, as seen in the following diagram.

Figure 11: System of Saving Group’s External Loan



3. Analyzing the Impact and the Services of the Saving Group

Phouphet KYOPHILAVONG
Chansathith CHALEUNSINH

Summary

In Laos, in order to combat poverty by improving living standards and raising the incomes of poor families in rural areas, the Lao Women's Union (LWU) in cooperation with international NGOs has established microfinance, called "the Saving Group". This Saving Group is one kind of micro-finance providing micro-saving, micro-insurance and micro-credit to members. Due to a lack of research, questions about the Saving Group have been raised: Does the Saving Group have an effect on the reduction of poverty? Is the Saving Group is appropriate in Laos? Is it a sustainable system? Therefore, this paper attempts to make clear these questions. It focuses on analyzing the effects of the Saving Group on borrowing and saving behaviors of members and evaluates it's services.

The results can be summarized as follows:

The main reasons for joining the Saving Group are *Can borrow for emergencies (36.17%)*, *Can borrow for investment in agriculture (14.1%)*, and *Can borrow for children's education* (13.3%).

94.3 % of members want to increase their savings in the Saving Group. And 64.2 % of members want to borrow more after repayment of their loan. This indicates that the willingness to save is high and the demand for borrowing in the Saving Group is also high

The Saving Group has an effect on the saving behaviors of members if compare with non-members. Due to join the Saving Group, the saving attitudes by buying gold, livestock, jewelry, depositing money in the bank, and keeping keeping money at home of the members have shifted to saving in the Saving Group.

If compared between members and non-members, the Saving Group has the effect of increasing the number of loans, but the Saving Group doesn't have any effect on reducing interest rates, period of loan and the amount of money borrowing by members in comparison with non-members.

If comparing the borrowing pattern before and after joining the Saving Group, the Saving Group has the effect of increasing the numbers of loans and the amount of money borrowed and lengthening the period of loan of members; it also has the effect of lowering the loan interest rate compared with before

joining the Saving Group.

The main issues with the Saving Group services are the high loan interest rate, the insufficient size of loans, the difficult loan application procedure, and the unequal system of providing loans.

The total trust of the Saving Group is quite high. And the willingness to continue to join the Saving Group is high.

18.8% of members do not make their savings deposits on time, and all of them have been given some leeway by the Saving Group committee.16.3% of members did not make loan repayment on time and 95% of them were given some leeway by the Saving Group committee. This indicates that there are some ethical issues with regard to saving and loan repayment, and that the Saving Group regulations are not strict enough.

63.29% of non-members don't know about the Saving Group in their own village. This indicates that either the advertisement or the appeal of the Saving Group is not good enough. But on the other hand, 60% of non-members want to join the Saving Group.

Based on research results, the authors have a suggestion as follows:

The Saving Group plays an important role in increase savings and borrowing to improve the living standards and raise income of members. Therefore, the expansion of the Saving Group in rural poor areas is vital.

The demand for loans is high, but the supply is low. In addition, the interest rate is quite high in the Saving Group. The government should provide some loans to aid the good performance of the group and fill the gap between supply and demand and lower interest rate. In addition, the Saving Group must improve its service such as: the loan application procedure and equality in the provision of loans to members.

For the Saving Group to be sustainable, it is important that the Saving Group enforce its regulations and raise the level of trust in the Saving Group to compel members to make saving deposits and loan repayment on time.

With regard to boosting the Saving Group's membership and raising the amount of savings, it is important for the Saving Group's president or members themselves to explain the benefits of the Saving Group to non-members, to encourage them to join the Saving Group.

3. Analyzing the Impact and the Services of the Saving Group

Chapter 1. Introduction

The government of Lao PDR has stated as its millennium development goal the total elimination of poverty and the removal of least developed country status by 2020. To achieve this goal, one of the best tools with which to combat poverty is microfinance, which is widely used in developing countries throughout the world.

In Laos, in order to combat poverty by improving living standards and raising the incomes of poor families in rural areas, microfinance initiatives have been implemented throughout the country by the government, donors, NGO's and multi/bi-lateral agencies, which provide micro-saving facilities, micro-insurance and access to micro-credit.

One of the biggest microfinance operations, called "Saving Group" has been implemented by the Lao Women's Union (LWU) in cooperation with the Foundation for Integrated Agricultural Management (FIAM) and the Community Organization Development Institute: Thailand (CODI). This saving group is one kind of microfinance providing micro-saving, micro-insurance and micro-credit (Table1-1). The Saving Group was started in 1997. According to the FIAM and CODI monitoring sheet for May 2004, there are 231 Saving Groups in the capital Vientiane and 2 provinces, with a total of 23,080 members and total savings of 7,136.48 millions Kip.

However, this saving group is still new in Laos and there are problems still to be tackled; the accounts system and group regulations are simple. So far unresearched questions about the Saving Group need to be answered: Does the Saving Group have an effect on the reduction of poverty? Is the Saving Group appropriate for Laos? Is it a sustainable system? Therefore, it is vital to examine the effect of the Saving Group and to evaluate the Saving Group's services. On the basis of this research, we can discover the appropriate policies to support the Saving Group in order to combat poverty in both the short and long term.

Table1-1. The Saving Groups run by LWU

Province		District	Implementing Agency	No. of villages	No. of Saving Groups	Coverage	Members	Savings (million Kips)
					May of 2004			
VTN cap	1	Xaythany	FIAM	103	95	92%	11,484	5105.95
	2	Xaysetha	FIAM	52	4	8%	499	13.53
	3	Naxaythong	CODI	56	23	41%	2,237	30.30
	4	PakNgum	CODI	53	53	100%	4,304	1373.21
	5	Santhong	CODI	37	17	46%	1,253	219.55
				301	***192***	***64%***	***19,777***	6742.54
VTN prov.	6	Thoulakhom	FIAM	74	6	8%	755	122.60
	7	Viengkham	FIAM	18	7	39%	597	32.29
				92	***13***	***14%***	***1,352***	154.89
Khammuane	8	Thakhek	FIAM	141	24	17%	1,870	207.21
	9	Hinboune	FIAM	166	2	1%	81	31.84
				307	***26***	***8%***	***1,951***	239.05
		Total		700	231	33%	23,080	7136.48

FIAM: Foundation for Integrated Agricultural Management

CODI: Community Organizations Development Institute: Thailand

Sources: FIAM and CODI monitoring sheets

On the basis of the issues mentioned above, the main objectives of this research are as follows:

1) To study the characteristic saving and borrowing habits of members[1].
2) To analyze the effects of the Saving Group on the saving and borrowing habits of members[2].
3) To evaluate the Saving Group's service system.

This paper consists of 6 chapters. Chapter 1 is the introduction. Chapter 2 describes the case study and questionnaire design. Chapter 3 gives a profile of sample households. Chapter 4 analyzes the impact of the Saving Group on the saving and borrowing habits of members. Chapter 5 evaluates the Saving Group's services. Chapter 6 gives our conclusions and policy suggestions.

[1] 'Members' refers to members of the Saving Group: 'non-members' means those who are not members of the Saving Group.

[2] According to Puhazhendhi. V and Satyasai. K. J. S (2000), the Saving Group has a far-reaching impact, including an impact on income, on poverty reduction, on self-worth, on communication, etc. This paper, however, focuses on the impact of the Saving Group on the saving and borrowing habits of the Saving Group's members, as a vital role of the Saving Group is to provide micro-saving, micro-insurance and micro-credit.

Chapter 2. The case study and questionnaire design

This chapter will discuss the characteristics of the case study, and describe the questionnaire design. First, we will give an outline of the Saving Group used as the case study, and its regulations. Then, the authors will describe the methods used in the survey. Finally, the items of the questionnaire will be described.

2-1 Characteristics of the case study

The authors chose Housieng village in the Saythany district of Vientiane city as the case study, because of its proximity and the ease with which data could be collected, and because the Saving Group is a medium-sized group that serves as a good model for research.

A brief overview of Housieng village is as follows:

- 430 households – population 2,128 (1,167 female: 300 LWU members, March 2004)
- All households have electricity and clean water
- Household income is from agriculture
- The Saving Group was established on August 25, 1998
- 264 members; 99% of the Saving Group's members are LWU members (March 2004)
- Total savings 1,160,888 million kips (March 2004)

The regulations of the saving group in each village differ, in line with the decisions of the members, group leader and committee. The Housieng Saving Group's regulations are as follows:

- Minimum saving is 5,000 Kips per month (Unlimited maximum)
- Members can save in Kips, Baht and Dollars
- Members can borrow up to 5 times the amount they have saved
- The borrowing period is 3-5 months
- Interest rate is 5% per month
- Men and children can save, but may not borrow
- The membership fee is 2,000 kips
- A member who fails to save for 3 successive months will be excluded from the Group
- Savings are accepted only on the 12th and 13th of each month, and borrowing day is the night of the 13th every month

2-2 Survey method

A questionnaire was used to collect primary data, and the survey was split into two parts as follows:

- First survey 12 – 13 March 2004 (Saving group members, 196 replies collected)
- Second survey 15 June 2004 (Non- members of the saving group, 81 replies collected)

2-3 Questionnaire items

The questionnaire items were divided into 3 parts:

(1) Profile of members and non-members:

- Age, sex	- Family
- Sources of income	- Saving, borrowing habits, etc

(2) Impact of the Saving Group:

- Effect on saving and borrowing (Before and After)
- Effect on saving and borrowing (Members and non-members)

(3) Evaluation of saving group's services

- Confidence in the committee
- Saving and borrowing services
- The ethics of saving and repayment

Chapter 3. Profile of sample households

This chapter will discuss the profile of members and non-members. A discussion of the special features of saving in the Saving Group will be followed by a discussion of the special features of borrowing in the Saving Group.

3-1 Profile of Saving Group members and non-members

(1) Characteristics of the sample

Table 3-1 shows a comparison of the characteristics of Saving Group members and non-members.

90.26% of the members of the Saving Group are women, and 64.2% of non-members are women. The average age of Saving Group members is 41.12 years and of non-members, 43.12 years.

20.51 % of Saving Group members and 24.69% of non-members are illiterate. For both members and non-members, the average number of children is three per household.

85.05% of Saving Group members and 81.25% of non-members were born in the village. 85.05 % of Saving Group members have relatives in this village, as do 81.25 % of non-members.

The main occupation is farming; 81% of Saving Group members and 71.60 % of non-members are farmers. The main occupation of husband or wife in either group is farming.

(2) Assets

Table 3-2 shows a comparison of the assets of Saving Group members and non-members.

There is not much difference between the two groups in the ownership of cars, motorbikes, bicycles, TVs, refrigerators etc, but ownership of mobile phones, tractors, radio cassettes and radios is higher among Saving Group members.

The results indicate that Saving Group members have greater assets than non-members in some respects.

Table 3-1. Characteristics of Saving Group members and non-members

	Members		Non-members	
	Persons	Percent	Persons	Percent
Sex				
Female	176	90.26	52	64.20
Male	19	9.74	29	35.80
Age				
-20	8	4.10	6	7.41
21-40	86	44.10	35	43.21
41-60	89	45.64	25	30.86
61-	12	6.15	15	18.52
Average (years)		41.12		43.12
Marital status				
Married		93.85		91.36
Single		6.15		8.64
Education				
Illiterate	40	20.51	20	24.69
Primary school	50	25.64	18	22.22
Secondary school	54	27.69	17	20.99
High school	32	16.41	13	16.05
Tertiary education	7	3.59	5	6.17
Other	12	6.15	8	9.88
Children				
None	18	9.23	17	20.99
1-3 persons	110	56.41	41	50.62
4-6 persons	51	26.15	17	20.99
7- persons	16	8.21	6	7.41
Average (persons)		3.29		3.22
Born in this village				
Yes	165	85.05	65	81.25
No	29	14.95	15	18.75
Relative in village				
None	35	17.95	20	24.69
1-3 families	76	38.97	36	44.44
4-6 families	64	32.82	16	19.75
7- families	20	10.26	9	11.11
Average (families)		3.98		3.52
Main occupation				
None	1	0.51	4	4.94
Farmer	159	81.54	58	71.60
Government officer	10	5.13	5	6.17
Trade	8	4.10	5	6.17
Worker	1	0.51	1	1.23
Housewife	5	2.56	2	2.47
Other	11	5.64	6	7.41
Main occupation of husband or wife				
None	56	28.72	32	39.51
Farmer	87	44.62	35	43.21
Government Officer	10	5.13	3	3.70
Private company	1	0.51	0	0.00
Own business	1	0.51	0	0.00
Trade	12	6.15	2	2.47
Worker	10	5.13	3	3.70
Housewife	2	1.03	2	2.47
Other	16	8.21	4	4.94

Source: the authors

Table 3-2. Assets of Saving Group members and non-members

(Percent)

Assets	Members	Non-members
Car	9.70	7.40
Motorbike	49.74	50.62
Bicycle	79.49	76.54
TV	85.13	86.42
Refrigerator	63.08	64.20
Telephone	3.59	3.70
Mobile phone	23.08	16.05
Electric fan	87.18	83.95
Tractor	6.67	0.00
VCD player	49.74	44.44
Sewing machine	16.41	13.58
Radio cassette	42.05	28.40
Radio	26.67	16.05

Source: the authors

(3) Income

Table 3-3 shows the total average annual income of Saving Group members and non-members. The main sources of income of the two groups are other than from agriculture. Income from sources other than agriculture accounts for 78.20 % of the total income of the Saving Group members and for 67.36 % of the total income of non-members. This shows that the Saving Group members have 30 % higher income than non-members.

The results show that the Saving Group members have higher incomes than non-members.

Table 3-3. Income of Saving Group members and non-members

	Members		Non-Members	
	100,000 Kips	Percent	100,000 Kips	Percent
Total average income per year	226.19	100.00	151.16	100.00
Agriculture income	49.32	21.80	49.35	32.64
Farming	31.69	14.01	21.76	14.40
Plantation	9.85	4.35	10.25	6.78
Livestock	7.78	3.44	17.33	11.47
Other income	176.88	78.20	101.81	67.36
Trade	45.59	20.16	27.75	18.36
Wage from main job	29.70	13.13	39.42	26.08
Wage from part-time job	66.08	29.21	18.54	12.26
Relative overseas	35.51	15.70	16.10	10.65

Source: the authors

(4) Saving and borrowing in the Agriculture Promotion Bank (APB)

Table 3-4 shows saving and borrowing in the APB by members and non-members. Knowledge of the APB is higher among members (45.13%) than non-members (23.46%).

More members (9.74%) save in the APB than non-members (2.47%), but the average amount of savings by members is smaller than by non-members.

Fewer members (7.18%) borrow from the APB than non-members (54.32%), but the average amount borrowed by members is greater than the average amount borrowed by non-members.

The results indicate that non-members are more dependent than members on the APB for saving and borrowing money, but non-members save and borrow smaller amounts than members.

Table 3-4. Agriculture Promotion Bank (APB)

	Members	Non-members
Know (%)	45.13	23.46
Saving (%)	9.74	2.47
Average amount saved		
Kip (10,000)	30.26	40
Baht	0	0
Dollar	0	0
Borrowing (%)	7.18	54.32
Average amount borrowed		
Kip (10,000)	25.05	12.5
Baht	0	0
Dollar	0	0

Source: the authors

3-2 Saving trends in the Saving Group

(1) Length of Saving Group membership and amount of savings

Table 3-5 shows a general overview of saving habits. The average length of membership is 23 months. The average amount of savings is 1,597,000 Kips.

The average amount of savings last year was 1,751,000 Kips. Income from interest last year was 160,000 Kips[3].

[3] The authors calculate 1US Dollar = 10,000 Kips, and 1 Thai Baht= 265 Kips.

Table 3-5. Length of Saving Group membership and amount of savings

Period of being Saving Group member (months)	23.10
The amount of money in saving account (now)	
Kip (100,000)	15.96
Baht (1000)	5.00
Dollar	0.00
Total in kip (100,000)	15.97
The amount of money in saving account last year (December)	
Kip (100,000)	17.51
Baht (1000)	1.00
Dollar	0.00
Total in kip (100,000)	17.51
Income from interest last year (100,000 Kips)	1.60

Source: the authors

(2) Reasons for joining the Saving Group

Table 3-6 shows the reasons for joining the Saving Group. The main reasons for joining the saving group are *Can borrow for emergencies* (36.17%), *Can borrow for investment in agriculture* (14.1%) and *Can borrow for children's education* (13.3%).

Table 3-6. Reasons for joining the Saving Group

	Persons	Percent
Can borrow for investment in agriculture	53	14.10
Can borrow to buy consumption goods	15	3.99
Can borrow for business	22	5.85
Can borrow for emergencies	136	36.17
Can borrow for children's education	50	13.30
To increase savings	41	10.90
Income from interest	16	4.26
To helping poor villagers	19	5.05
Friendship with other villagers	24	6.38
Total	376	100.00

Source: the authors

(3) The desire to save more in the Saving Group

Table 3-7 shows the desire to save more in the Saving Group. 94.3% of members want to increase their savings in the Saving Group.

Table 3-7. Desire to save more in the Saving Group

	Persons	Percent
Want to save more	183	94.30
Don't want to save more	8	4.10
Other	3	1.50

Source: the authors

3-3 Borrowing trends in the Saving Group

(1) Borrowing trends of members

Table 3-8 shows the borrowing trends of members. 61.7% of members are now borrowing money from the Saving Group, and 60.8% of members have something to offer as security when borrowing.

The average amount of money borrowed is 1,959,000 Kips. The average loan period is 5.21 months, and the interest rate is 5% per month.

Table 3-8. Borrowing trends of members

	Persons	Percent
Current loan from the Saving Group	119	61.70
Can provide security when borrowing	73	60.80
The average size of loan		
Kip(100,000)	9.58	
Baht (1000)	2.00	
Dollar	100.00	
Total in kip (100,000)	19.59	
The average loan priod (months)	5.21	
Monthly interest rate (percent)	5.00	

Source: the authors

(2) Desire to borrow

Table 3-9 shows the desire to borrow and reasons for not borrowing. 64.2% of members want to borrow more after repayment of their loan. The main reasons for not borrowing are *No plan to do agriculture* (59.5%), *No plan to do business* (31%) and *Interest rate is high* (7.1%).

If the interest rate were to rise from 5% to 7% per month (Table 3-10), 60% of members would still want to borrow money from the Saving Group. The main reasons for not borrowing are *Interest rate is high* (52.6%), *No plan to do agriculture* (23.7%), and *No plan to do business* (13.2%).

The results show that the desire to save in the Saving Group is high, and even when the interest rate rises, the demand for loans from the Saving Group is still high.

Table 3-9. The desire to borrow more, and reasons

	Persons	Percent
Desire to borrow more	79	64.20
Reason for not desiring a loan		
No plan to do agriculture	25	59.50
No plan to do business	13	31.00
Cannot borrow the amount needed	1	2.40
Loan period is too short	0	0.00
Interest rate is high	3	7.10
Total	42	100.00

Source: the authors

Table 3-10. Desire to borrow more

	Persons	Percent
Desire to borrow more (Interest rate up from 5% to 7%)	75	60.00
Reasons for not desiring a loan		
No plan to do agriculture	9	23.70
No plan to do Business	5	13.20
Cannot borrow the amount needed	3	7.90
Loan period is too short	1	2.60
Interest rate is high	20	52.60
Total	38	100.00

Source: the authors

Chapter 4. The impact of the Saving Group

Previous studies in other countries have shown that the Saving Group has an effect on members in many different ways. In this chapter, we will focus on the impact on the saving and borrowing habits of members, because of the limitation of data and because it is the most important role of the Saving Group. First, the impact of the Saving Group on saving habits will be discussed, followed by the impact of the Saving Group on borrowing habits.

4-1 The impact of the Saving Group on saving habits

(1) Comparison of Saving Group members and non-members

Table 4-1 shows a comparison between the saving habits of members and non-members.

Saving by buying gold: members 15.9%, non-members 29.63%. The average amount of gold in the two groups is almost the same[4].

Saving by buying silver: members 3.85%, non-members 2.56%. The average amount of silver held by members is greater than that held by non-members[5].

Saving in bank: members 5.52%, non-members 8.86%. The average total amount of savings of members is 7,106,000 Kips, and of non-members, 2,957,000 Kips.

Saving by buying livestock: members 32.39%, non-members 44.87%.
Saving by buying jewelry: members 3.87%, non-members 3.90%.
Keeping money at home: members 65.78%, non-members 71.25%.

The results show that members are less likely to save by buying gold or livestock, depositing money in the bank or keeping money at home than non-members are. This shows that the Saving Group has an effect on the saving habits of members.

The main purposes for saving by the two groups are *for emergencies*; *for children's education* and *for old age*.

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[4] According to market prices in Vientiane city on January 30, 2005, 1 Baht of pure gold (15.12 g) is worth 215 US dollars or 2,150,000 Kips (1 US dollar= 10000 Kips).

[5] According to market prices in Vientiane city on January 30, 2005, 1 Baht of pure silver (15.12 g) is worth 3,975 Kips.

Table 4-1. Comparison of the saving habits of members and non-members

	Members	Non-members
Gold (%)	15.90	29.63
Average amount of gold (Baht*)	5.86	6.26
Silver (%)	3.85	2.56
Average amount of silver (Baht)	14.33	3.00
Bank (%)	5.52	8.86
Amount of money		
Kip(100,000)	70.00	29.57
Baht	400	0.00
Dollar	0	0.00
Total in Kip (100,000)	71.06	29.57
Livestock (%)	32.39	44.87
Jewelry (%)	3.87	3.90
Keep at home (%)	65.78	71.25
Purposes of saving		
To build a house (%)	8.31	10.79
Children's education (%)	24.40	22.30
For emergency (%)	37.80	40.29
For old age(%)	10.19	10.79
Investment/Trading (%)	5.90	6.47
To buy TV, VCD,etc (%)	1.61	0.72
Agricultural product (%)	8.85	6.47
To buy car, motorbike (%)	2.95	2.16

Note: 1 Baht*= 15.12 g = 215 US dollars (Jamuary 2005)

Source: the authors

(2) Before and after joining the Saving Group

Table 4-2 shows a comparison of saving habits before and after joining the Saving Group. Before joining the Saving Group 41.03% saved by buying gold, but after joining the Saving Group this dropped to 15.9%. The average amount of gold held before joining the Saving Group was 9.13 Baht, and after joining 6.77 Baht.

The percentage of people who saved by buying silver remained the same before and after joining the Saving Group, but the average amount of silver held before joining the Saving Group (40.00 Baht) was more than after joining the Saving Group (14.33 Baht).

The percentage of those who saved in the bank before joining the Saving Group fell from 17.44% to 5.52%, and the percentage of those who saved by buying livestock also dropped from 51.28% to 32.39%.

The percentage that saved by buying jewelry before joining the Saving Group also fell from 12.31% to

3.87%. The percentage of those who saved by keeping money at home fell from 66.67% to 65.78%.

These results indicate that joining the Saving Group has an effect in reducing saving by buying gold, livestock and jewelry, depositing money in the bank, and keeping money at home. This means that there has been a shift from saving by buying gold, animals and jewelry, depositing money in the bank or keeping money at home, to saving in the Saving Group.

The main purposes of saving both before and after joining the Saving Group are the same; *for emergencies*, *children's education* and *for old age*.

Table 4-2. Comparison of saving habits before and after joining Saving Group

	Before	After
Gold (%)	41.03	15.90
Average amount of gold (Baht*)	9.13	5.86
Silver (%)	4.62	3.85
Average amount of silver (Baht)	40.00	14.33
Bank (%)	17.44	5.52
Amount of money		
Kip (100,000)	41.27	70.00
Baht	20,000.00	400.00
Dollar	3,800.00	0.00
Total in Kip (100,000)	474.27	71.06
Livestock (%)	51.28	32.39
Jewelry (%)	12.31	3.87
Keep at home (%)	66.67	65.78
Purposes of saving		
To build a house (%)	7.92	8.31
Children's education(%)	22.13	24.40
For emergency (%)	39.07	37.80
For old age(%)	12.02	10.19
Investment/Trading(%)	6.01	5.90
To buy TV, VCD, etc(%)	1.64	1.61
Agriculture product(%)	8.74	8.85
To buy car, motorbike(%)	2.46	2.95

Note: 1 Baht*= 15.12 g = 215 US dollars (Jamuary 2005)

Source: the authors

4-2 The impact of the Saving Group on borrowing habits

(1) Comparison between Saving Group members and non-members

Table 4-3 shows a comparison of the borrowing habits of Saving Group members and non-members. Money-borrowing patterns: 78.58% of members have borrowed money, and 24.69% of non-members have borrowed money.

94.56% of members borrow from the Saving Group, and 3.71% from relatives On the other hand, 83.33% of non-members borrow from friends, and 13.33% borrow from the bank.The average amount of money borrowed by members is 5,351,000 Kips and by non-members, 7,865,000 Kips. This shows that the average amount borrowed by non-members is higher than that borrowed by members.

The average interest rate per month for members is 5.25% and for non-members, 2.06%.

The average loan period is 4.88 months for members, and 6.10 months for non-members.

The results indicate that in a comparison between members and non-members, the Saving Group has the effect of increasing the number of loans; but the Saving Group does not have any effect on reducing interest rates, period of loan or the amount of money borrowed by members in comparison with non-members.

The main purposes of borrowing by members are for *agriculture* (34.38%), *Emergency* (18.23%) and *trade* (11.79%). For non - members the main purposes are for *agriculture* (12.35%), *Emergency* (7.41%) and *trade* (3.70%).

Table 4-3. Comparison of borrowing habits of Saving Group members and non-members (1)

	Agriculture		Trade		Education		Buy Goods		Emergency		Total	
	Members	Non-members	Members	Non-members	Members	Non-members	Members	Non-members	Members	Non-members	Members	Non-members
Borrow money												
Borrow (%)	34.38	12.35	11.79	3.70	10.00	1.23	4.19	0.00	18.23	7.41	78.58	24.69
Don’t borrow (%)	65.63	87.65	88.21	96.30	90.00	98.77	95.81	100.00	81.77	92.59	21.42	75.31
Borrow money from												
Saving Group (%)	89.66	0.00	95.65	0.00	87.50	0.00	100.00	0.00	100.00	0.00	94.56	0.00
Relative (%)	1.72	10.00	4.35	0.00	12.50	0.00	0.00	0.00	0.00	0.00	3.71	3.33
Friend (%)	0.00	50.00	0.00	100.00	0.00	100.00	0.00	0.00	0.00	0.00	0.00	83.33
Bank (%)	6.90	40.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.38	13.33
Other (%)	1.72	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.34	0.00
Amount of borrowed												
Kip(100,000)	6.96	13.89	9.89	50.00	5.44	4.00	15.43	0.00	5.73	10.50	43.45	78.39
Baht(1000)	2.00	50.00	0.00	50.00	0.00	0.00	0.00	0.00	20.00	0.00	22.00	100.00
Dollar	0.00	0.00	0.00	0.00	0.00	0.00	100.00	0.00	0.00	0.00	100.00	0.00
Total in Kip (100,000)	6.97	14.02	9.89	50.13	5.44	4.00	25.43	0.00	5.79	10.50	53.51	78.65

Source: the authors

Table 4-3. Comparison of borrowing habits of Saving Group members and non-members (2)

	Agriculture		Trade		Education		Buy goods		Emergency		Average	
	Members	Non-members	Members	Non-members	Members	Non-members	Members	Non-members	Members	Non-members	Members	Non-members
Interest rate per month (%)	5.56	5.34	4.90	2.95	5.94	2.00	5.00	0.00	4.84	0.00	5.25	2.06
Period of loan (month)	5.44	7.75	5.89	12.50	3.79	6.00	4.00	0.00	5.28	4.25	4.88	6.10

Source: the authors

(2) Before and after joining the Saving Group

Table 4-4 shows a comparison of the borrowing habits of members before and after joining the Saving Group.

Before joining the Saving Group, 46.52% of members had borrowed money, but after joining the Saving Group this jumped to 78.78%.

Before joining the Saving Group, members mainly borrow from their relatives (40.07%), the bank (20.45%) and other people (13.05%). After joining the Saving Group, members borrow from the Saving Group (99.56 %), their relatives (3.71 %), and the bank (1.38 %).

After joining the Saving Group, the average amount borrowed by members nearly doubled compared with before joining the Saving Group.

After joining the Saving Group, the monthly interest rate dropped from 10.12% to 5.25%.

These results indicate that the Saving Group has the effect of increasing the number of loans and the amount of money borrowed and lengthening the period of loan of members; it also has the effect of lowering the loan interest rate compared with before joining the Saving Group.

Both before and after joining the Saving Group, the main reasons for borrowing are: *agriculture*, *emergency* and *trade*.

Table 4-4. Comparison of borrowing habits before and after joining the Saving Group (1)

	Agriculture		Trading		Education		Emergency		Buy goods		Total	
	Before	After	Before	After	Before	After	Before	After	Before	After	Before	After
Borrow money												
Borrow (%)	20.83	34.20	3.68	12.17	4.21	10.00	17.28	18.23	0.52	4.19	46.52	78.78
Don't borrow (%)	79.17	65.80	96.32	87.83	95.79	90.00	82.72	81.77	99.48	95.81	53.48	21.22
Borrow money from												
Saving Group (%)	0.00	89.66	0.00	95.65	0.00	87.50	0.00	100.00	0.00	100.00	0.00	94.56
Relative (%)	18.42	1.72	28.57	4.35	80.00	12.50	73.33	0.00	0.00	0.00	40.07	3.71
Friend (%)	7.89	0.00	14.29	0.00	0.00	0.00	10.00	0.00	0.00	0.00	6.44	0.00
Bank (%)	73.68	6.90	28.57	0.00	0.00	0.00	0.00	0.00	0.00	0.00	20.45	1.38
Other (%)	0.00	1.72	28.57	0.00	20.00	0.00	16.67	0.00	0.00	0.00	13.05	0.34
Amount of borrowed												
Kip(100,000)	8.57	6.96	8.00	9.89	3.29	5.44	4.30	5.73	0.00	15.43	24.16	43.45
Baht (1000)	3.00	2.00	10.00	0.00	0.00	0.00	1.00	20.00	0.00	0.00	14.00	22.00
Dollar	21.50	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	100.00	21.50	100.00
Total in Kip (100,000)	10.73	6.97	8.03	9.89	3.29	5.44	4.30	5.78	0.00	25.43	26.35	53.50

Source: the authors

Table 4-4. Comparison of borrowing behaviors before and after joining the Saving Group (2)

	Agriculture		Trading		Education		Emergency		Buy goods		Average	
	Before	After	Before	After	Before	After	Before	After	Before	After	Before	After
Monthly interest rate (%)	9.67	5.56	10.60	4.90	15.00	5.94	15.35	4.84	0.00	5.00	10.12	5.25
Period of loan (months)	7.75	5.44	12.50	5.89	6.00	3.79	4.25	5.28	0.00	4.00	6.10	4.88

Source: Authors

Chapter 5. Evaluation of Saving Group services

This chapter will discuss the evaluation of the Saving Group's services from the point of view of the members. First, the Saving Group's services will be discussed, then the confidence of members in the Saving Group and the ethics of saving and repayment. Finally, non-members' awareness of the Saving Group will be discussed.

5-1 The Saving Group's services

Table 5-1 shows the level of satisfaction with the 13 Saving Group services. Some of the most unsatisfactory services are the loan interest rate (11.6%), size of loan (7.7%), loan procedure (6.3%), and equality in loans (5.7%).

These results show that the main issues with the Saving Group services are the high loan interest rate, the insufficient size of loans, the difficult loan application procedure, and the unequal system of providing loans[6]

Table 5-1. Level of satisfaction with Saving Group services

(Percent)

	Not satified	Neutral	Satified
Loan interest rate	11.60	19.20	69.20
Load period	5.50	16.60	77.90
Size of loan	7.70	16.80	75.50
Loan procedure	6.30	24.60	69.00
Loan approval	4.90	18.20	76.90
Guarantee system	3.60	39.10	57.20
Saving procedure	1.50	24.80	73.70
Saving Group committee advice on loans and savings	0.70	16.90	82.40
Saving Group committee advice on agriculture	2.80	26.60	70.60
Saving Group committee advice on business, trade, etc	3.60	31.40	65.00
Loan equality	5.70	16.30	78.00
Opportunity to have one's opinion heard in the Saving Group	1.40	22.70	75.90

Source: the authors

5-2 Confidence in the Saving Group

Table 5-2 shows the level of trust in the Saving Group. Trust in the Saving Group can be broken down into trust of the president, of the advisers and of the elders. Generally, Lao people don't make negative comments on their leaders or committees when asked by an outsider. Therefore the authors used "neutral" to indicate the lowest level of trust in the Saving Group. The members' level of trust in the Saving Group

[6] Because of the lack money in the Saving Group and the high demand for loans, the Saving Group committee decides which members will be able to borrow.

is lowest for the Saving Group's advisers (20.83%)

The results indicate that the overall level of trust in the Saving Group is quite high. The desire to continue as a member of the Saving Group is also high.

Table 5-2. Level of trust in the Saving Group

(Percent)

	Neutral		Trust		Very trust	
	Members	Non-members	Members	Non-members	Members	Non-members
President	17.62	40.79	37.31	40.79	45.08	18.42
Adviser	20.83	42.11	42.19	46.05	36.98	11.84
Elder	17.80	40.79	40.84	47.37	41.36	11.84

Source: the authors

Table 5-3 shows the perceived sustainability of the Saving Group. 78.2% of members think that the Saving Group is sustainable. 97.9% of members will continue as members of the Saving Group (Table5-4)

Table 5-3. Perceived sustainability of the Saving Group

	Persons	Percent
Sustainable	151	78.20
Not sustainable	0	0.00
Don't know	42	21.80
Total	193	100

Source: the authors

Table 5-4. Willingness to remain a member of the Saving Group

	Persons	Percent
Remain a member	189	97.90
Don't want to remain a member	2	1.00
Don't know	2	1.00
Total	193	100

Source: the authors

5-3 The ethics of members with regard to saving and borrowing

Table 5-5 shows 18.8% of members do not make their savings deposits on time, and all of them have been given some leeway by the Saving Group committee.

It also shows that 16.3% of members did not make loan repayments on time, and 95% of them were given some leeway by the Saving Group committee.

This indicates that there are some ethical issues with regard to saving and loan repayment, and that the

Saving Group regulations are not strict enough.

Table 5-5. Saving and loan repayment by members

	Persons	Percent
Failure to make saving deposit on time	36	18.80
Given some leeway by committee	31	96.90
Average number of times saving deposit not made on time	2.56	
Loan repayment not on time	23	16.30
Given some leeway by committee	22	95.65
Average number of times loan repayment not made on time	1.5	

Source: the authors

5-4 Non-member awareness of the Saving Group

Table 5-6 shows that 63.29% of non-members don't know about the Saving Group in their own village. This indicates that either the advertisement or the appeal of the Saving Group is not good enough.

Table 5-6. Non-members awareness of the Saving Group

	Persons	Percent
Know about Saving Group	50	63.29
Don't know	29	36.71
Total	79	100.00

Source: the authors

Table 5-7 shows the desire of non-members to join the Saving Group. 60% of non-members want to join the Saving Group. The main reasons non-members do not desire to join the Saving Group are *Lack of money* (59.37%) and *Lack of confidence in the Saving Group* (9.37%).

Table 5-7. Non-members desire to join the Saving Group

	Persons	Percent
Want to join the Saving Group	45	60.00
Don't want to join	14	18.67
Don't know	16	21.33
Total	75	100.00
The reasons for not wanting to join the Saving Group		
Lack of money	19	59.38
Lack of confidence in Saving Group	3	9.38
Afraid of group collapse	1	3.13
Benefit from interest rate is small	1	3.13
Difficulty of saving / borrowing	1	3.13
Other	7	21.88
Total	32	100.00

Source: the authors

Chapter 6. Conclusions and policy suggestions

This paper attempts to investigate the impact of the Saving Group on the saving and borrowing pattern of its members, and to evaluate the Saving Group's services.

6-1 Conclusions

The conclusions of this paper can be summarized as follows:

Saving Group members have greater assets than non-members in some respects.

Members have higher incomes than non-members.

The main reasons for joining the Saving Group are *Can borrow for emergencies*, *Can borrow for investment in agriculture*, *Can borrow for children's education*.

94.3% of members want to save more in the Saving Group, and 64.2% of members want to borrow more after repayment of their loan. This indicates that the desire to save is high and that the demand for loans in the Saving Group is also high.

Members' custom of saving by buying gold, animals and jewelry, depositing money in the bank and keeping money at home has shifted to saving in the Saving Group.

In a comparison of the borrowing patterns of members and non-members, the Saving Group has the effect of increasing the number and the size of loans made by members over non-members. But the Saving Group has little effect on lowering the interest rate or lengthening the loan period for members.

If we compare borrowing patterns before and after joining the Saving Group, the Saving Group has the effect of increasing the number and size of loans made by members, lengthening the loan period and also lowering the loan interest rate.

The main issues regarding the Saving Group's services are the high interest rate on loans, the insufficient size of loans for members' needs, the difficult loan application procedure and the unequal loan system.

The overall level of trust in the Saving Group is quite high. The desire to remain a member of the Saving Group is also high.

18.8% of members fail to make saving deposits on time, 16.3% of members fail to make loan repayments on time, and most of them had been given some leeway by the Saving Group committee. This indicates that there are some ethical issues in saving and loan repayment, and that the Saving Group regulations are not strict enough.

63.29% of non-members don't know about the Saving Group in their own village.
This indicates that either the advertisement or the appeal of the Saving Group is not good enough.
On the other hand, 60% of non-members want to join the Saving Group.

6-2 Policy suggestions

On the basis of these research results, the authors make the following suggestions:

The Saving Group plays an important role in increasing savings and borrowing to improve the living standards and raise the income of members. Therefore, the expansion of the Saving Group in rural poor areas is vital.

The demand for loans is high, but the supply is low. In addition, the interest rate is quite high in the Saving Group. The government should provide some loans to aid the good performance of the group and fill the gap between supply and demand, and lower the interest rate. In addition, the Saving Group must to improve its services, such as the loan application procedure and equality in the provision of loans to members.

For the Saving Group to be sustainable, it is important that the Saving Group enforce its regulations and raise the level of trust in the Saving Group to compel members to make saving deposits and loan repayments on time.

With regard to boosting the Saving Group membership and raising the amount of savings, it is important for the Saving Group's president or members themselves to explain the benefits of the Saving Group to non-members, to encourage them to join the Saving Group.

6-3 Issues remaining to be addressed

This paper attempts to clarify the effects of the Saving Group on the saving and borrowing habits of members, and to point out issues with Saving Group services. However, this paper has weak points and needs to be updated as follows:

This paper focuses on only one case study and has a quite small sample base. Therefore, it is vital that the number of case studies and samples be increased.

The Saving Group affects members in many ways, including income, poverty reduction, self-worth, communication, etc. However, this paper focuses only on the effect on the saving and borrowing habits of members.

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