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January 27, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Lao People's Democratic Republic - Staff Report for the
1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with the Lao People's Democratic Republic. A draft decision appears on page 17.

This subject has been tentatively scheduled for discussion on Friday, February 17, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Evers (5)7611.

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INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

Staff Report for 1983 Article IV Consultation

Prepared by the Staff Representatives for the
1983 Article IV Consultation with Laos

Approved by Douglas A. Scott and Donald K. Palmer

January 27, 1984

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I. Introduction

Discussions for the 1983 Article IV consultations were held during October 29–November 12, 1983 in Vientiane. The staff team had discussions with Mr. Oudone Pholsena, First Vice Minister of Finance; Mr. Kikham Vongsay, Vice Minister of Finance; Mr. Somphavanh Inthavong, Vice President of the Planning Commission; Mr. Boutsabong Souvannavong, President of the State Banking Committee; and with officials of the Ministry of Finance, the National Bank of Laos, the State Planning Commission, the Ministry of Trade, and the Bank for External Trade. The staff team consisted of Messrs. Evers (Head of Mission), Kimura, Mendras (all ASD), Ms. Palanza (ASD), and Mrs. Kime (BLS, secretary).

Laos continues to avail itself of the transitional arrangements under the provisions of Article XIV and maintains exchange restrictions under those provisions.

II. Background and Recent Economic Developments

The economy of Laos is dominated by subsistence oriented agriculture and animal husbandry, which together account for about 75 percent of GDP and provide the main livelihood for about 80 percent of the population. The country is sparsely populated and, due to the mountainous terrain and the lack of adequate transportation, the urban centers are relatively isolated from one another and from the main food-producing areas. About 40 percent of the total land area is covered with forests and only about 3 percent--730,000 hectares--is under cultivation. The principal crop is glutinous rice, which is grown on 90 percent of the cultivated land. Agricultural yields are relatively low due to poor soil conditions and lack of adequate irrigation. Industrial production, which contributes about 7 percent to GDP, consists mainly of the generation of hydroelectricity and the processing of agricultural and forestry products. Hydroelectricity accounts for about 45 percent of total export earnings. Merchandise exports and imports are subject to high transportation costs through Thailand or must be transported over an arduous road connection to the Vietnamese port of Danang. For security reasons, Thailand does not permit the trans-shipment of about 230 products to Laos, but exemptions to this restriction are granted frequently.

After having experienced an average annual rate of growth of 8 percent during 1979–81, the Lao economy remained stagnant in 1982 and 1983. Further growth of the agricultural sector was affected by dry weather and a halt in the reclaiming of arable land, a major factor in the growth performance of previous years. Although rice availability remained sufficient and a resumption of large-scale foodgrain imports could be avoided, transportation bottlenecks and inefficiencies in the official distribution system continued to cause local shortages of major food items, particularly in the Vientiane area. This, together with adjustments in official retail prices and an acceleration in the rate of monetary expansion, led to a rise in inflation from 23 percent

in 1981 to 41 percent in 1982. A delay of about one month in the rice harvest, which gave rise to sharply higher food prices, contributed to a rise in inflation to an estimated 65 percent in 1983.

The steady improvement in budgetary performance that occurred during 1980-82 was partly reversed in 1983. Despite a reorganization of the tax system, the growth of current expenditure was in excess of the rise in domestic revenue, with the result that the public savings rate declined from 4.3 percent in 1982 to 3.1 percent in 1983 (Table 1). Most of the deterioration in the fiscal position stemmed from a sharp rise in outlays for "materials and supplies," which include defense expenditures, and a slowing in profit transfers from public enterprises. In September 1983, government salaries were raised by 50 percent, more or less in line with the increase in official retail prices since the previous salary adjustment in April 1982. After a sharp rise in 1982, profit transfers from public enterprises leveled off in 1983, as higher costs were not fully translated into higher prices. Profit transfers would actually have fallen had it not been for the fact that, starting in 1983, the government budget assumed part of the cost of consumer subsidies that were borne by the State Trading Corporation. As in previous years, the overall budget deficit in 1983 was entirely financed with foreign aid and, except for seasonal requirements, the Government has refrained from borrowing from the banking system.

The reorganization of the tax system, which became effective for the private sector in June 1983, included the adoption of higher rates for the profit tax and the salary tax; a change in the range of the rates for the turnover tax, resulting in a higher average rate; an increase in the business license tax; and higher import duties. In addition, the Government introduced measures to speed up the collection of taxes from the private sector and to provide for more accurate assessments of tax liabilities. For instance, most taxes are now collected every two weeks rather than every three or six months. Tax revenue from the private sector has been growing rapidly in recent years, i.e. from 1.9 percent of GDP in 1980 to 4 percent in 1983.

Monetary policies are largely designed to accommodate price and wage developments in the public sector and to provide public sector enterprises with sufficient credit to meet the annual production targets of the Plan. The growth of total liquidity rose from 4 percent in 1981 to 53 percent in 1982, a rate of increase that was somewhat in excess of the estimated growth rate in nominal GDP of 47 percent (Table 2). Although the authorities had aimed to slow the rate of growth of total liquidity during 1983, data for the first six months and the need to accommodate the rise in salaries that was granted in September, indicate that the increase in monetary aggregates may have been of the same order as in 1982.

Table 1. Laos: Budgetary Operations

(In millions of kip)

	1980	1981	1982	1983	
				Budget	Revised Estimates
Revenue	748	989	2,755	3,450	3,496
State enterprises	568	713	2,255	2,679	2,441
Operating surpluses	(312)	(420)	(1,595)	(1,890)	(1,684)
Private sector	98	200	415	490	728
Other revenue	82	76	85	281	327
Expenditures	1,777	1,956	5,475	6,550	6,695
Current expenditures	1,028	1,028	2,259	2,850	2,945
Wages and salaries	270	200	280	...	320
Subsidies on consumption	--	--	--	--	150
Debt service	23	45	96	100	100
Materials and supplies	668	725	1,798	...	2,170
Capital expenditures	749	928	3,216	3,700	3,750
Overall deficit (-)	-1,029	-967	-2,720	-3,100	-3,199
Foreign loans and grants <u>1/</u>	1,033	967	2,720	3,100	3,199
National Bank	-4	--	--	--	--
<u>Memorandum items:</u>					
Rice subsidy <u>2/</u>	--	82	224	...	392
(As percentage of GDP)					
Domestic revenue	14.2	12.8	24.2	...	19.4
Operating surpluses of public enterprises	5.9	5.4	14.0	...	9.3
Taxes on private sector	1.9	2.6	3.6	...	4.0
Current expenditures	19.6	13.3	19.8	...	16.3
Materials and supplies	12.7	9.4	15.8	...	12.0
Revenue minus current expenditure	-5.3	-0.5	4.3	...	3.1
Total expenditure	33.8	25.2	48.0	...	37.1
Overall deficit <u>3/</u>	19.6	12.4	23.9	...	17.7
Rice subsidy <u>2/</u>	--	1.0	2.0	...	2.2

Sources: Data provided by the Laos authorities; and staff estimates.

1/ Budget data on foreign aid may not correspond with balance of payments data because some aid receipts, such as for projects that remain under supervision and management of the donor country, are not channeled through the budget. On the other hand, some aid-in-kind recorded in the budget may have escaped the balance of payments accounts for both imports and capital receipts.

2/ The cost of the rice subsidy is borne mainly by the State Trading Corporation.

3/ The fluctuations in the overall deficit as a percentage of GDP are caused largely by the high rate of inflation and the large discretionary adjustments in the exchange rate.

Table 2. Laos: Factors Affecting Total Liquidity

(In millions of kip)

	1981	1982	1982 Jan.-June	1983 Jan.-June	1983 Amounts at end-June
Net foreign assets <u>1/</u>	<u>-78</u>	<u>85</u>	<u>157</u>	<u>-117</u>	<u>-556</u>
Domestic credit	226	263	5	115	1,503
Government	-37	-9	-11	-3	7
Public enterprises	243	257	15	99	1,411
Private sector	20	14	1	19	85
Other assets (net)	<u>-121</u>	<u>71</u>	<u>-30</u>	<u>168</u>	<u>433</u>
Total liquidity	<u>27</u>	<u>419</u>	<u>132</u>	<u>166</u>	<u>1,380</u>
Currency in circulation	12	67	62	39	275
Public enterprise deposits	32	333	59	99	983
Private sector deposits	-17	20	12	25	110
Savings deposits	--	-1	-1	3	12

Source: Data provided by the Laos authorities.

1/ Includes only assets and liabilities in convertible currencies and balances under bilateral trade and payments agreements with Viet Nam. Bilateral balances under trade and payments agreements by other CMEA countries are held with the State Trading Company.

After a 38 percent increase in 1982, imports are estimated to have remained unchanged in 1983, which, together with a rise in exports, contributed to a reduction in the current account deficit from \$79 million or 24 percent of GDP in 1982 to \$68 million or 13 percent of GDP in 1983 (Table 3). Exports rose by 31 percent in 1983; the increase was almost exclusively on account of the nonconvertible area. The deficit of transactions under bilateral trade and payments agreements with the nonconvertible area declined from \$17 million in 1982 to \$15 million in 1983. Since 1981, debit balances in excess of the limits provided for under these agreements have been converted into 30-year loans with a grace period of 10 years and an interest rate of 2 percent. Foreign aid disbursements declined because cash aid received from a donor in the convertible area during 1982 was not renewed in 1983. The fall in aid from the convertible area contributed to an overall balance of payments deficit of \$5.5 million in 1983. Gross

Table 3. Laos: Balance of Payments

(In millions of U.S. dollars)

	1980	1981	1982	1983 Jan.-June	1983 Estimate
Trade balance	-78.8	-70.8	-84.4	-51.4	-72.7
Convertible area	-28.5	-22.2	-17.1	-15.4	-17.3
Nonconvertible area	-4.7	-8.4	-17.3	-8.0	-15.4
Aid-financed imports <u>1/</u>	-45.6	-40.2	-50.0	-28.0	-40.0
Exports	13.5	19.4	39.8	28.8	52.3
Convertible area	13.5	14.0	26.9	14.8	27.7
Of which: Electricity	5.3	7.9	23.9	12.6	24.0
Nonconvertible area	...	5.4	12.9	14.0	24.6
Imports	-92.3	-90.2	-124.2	-80.2	-125.0
Convertible area	-42.0	-36.2	-44.0	-30.2	-45.0
Nonconvertible area	-4.7	-13.8	-30.2	-22.0	-40.0
Aid imports <u>1/</u>	-45.6	-40.2	-50.0	-28.0	-40.0
Services and transfers	-2.3	0.7	5.5	-7.1	5.0
Of which: Interest payments <u>2/</u>	-1.8	-2.0	-3.5	-3.3	-3.8
Current account	-81.1	-70.1	-78.9	-58.5	-67.7
Capital account	66.6	73.4	80.2	48.5	62.2
Official transfers <u>2/</u>	13.0	15.5	24.9	8.7	12.0
Drawings on loans	43.3	50.5	40.6	33.5	38.0
Convertible area	8.1	6.4	9.8	3.5	6.0
Nonconvertible area	35.2	44.1	30.8	30.0	32.0
Use of clearing arrangements	4.7	8.4	17.3	8.0	15.4
Loan repayments	-1.3	-3.7	-2.6	-1.7	-3.2
Other <u>3/</u>	6.9	2.7	--	--	--
Errors and omissions	3.5	-7.9	-5.4	9.6	--
Overall balance <u>2/</u>	-11.0	-4.6	-4.1	-0.4	-5.5
Change in reserves (increase -)	11.0	4.6	4.1	0.4	5.5
Assets	12.0	0.5	5.0	0.4	5.5
Liabilities	-1.0	4.1	-0.9	--	--

Source: Based on data provided by the Lao authorities.

1/ From both the convertible and the nonconvertible areas.

2/ Convertible area only.

3/ Including allocations of SDRs.

convertible foreign exchange reserves amounted to \$18.3 million at the end of September 1983, a period when reserves are seasonally at a high level. They are estimated to have declined to \$3.0 million at the end of December 1983, or about three weeks of cash imports from the convertible area. Foreign liabilities in convertible currencies, which consist mainly of outstanding purchases from the Fund, amounted to \$14.1 million at the end of December 1983.

Since January 1982, the commercial exchange rate, at which most official transactions take place, has remained unchanged at K 35 per U.S. dollar. In contrast, the exchange rate in the free market moved from K 56 to K 105 per U.S. dollar during 1982 and to K 120 per U.S. dollar in 1983. In July 1983, the authorities introduced a special rate of K 108 per U.S. dollar for private inward remittances.

III. Report on the Discussions

Despite recent progress, the Lao economy remains beset by a number of constraints that may seriously affect its future growth performance. Foremost among these are an undeveloped infrastructure, critical shortages of educated and trained manpower at all levels, organizational weakness in many government departments, persistent security problems in some areas, and a low rate of domestic savings. In addition, the conditions that favored economic growth in the past--possibilities for reclaiming large areas of arable land and excess capacity in some industries--no longer exist to the same extent. Further gains in agriculture will have to be preceded by substantial investment for land development and by the adoption of yield increasing techniques. Growth in industry will require more investment in new capacity and improvements in the basic infrastructure, particularly transportation and communication. In the absence of further domestic resource mobilization, a disproportionate amount of new investment will have to come from foreign sources. Laos is already heavily dependent on foreign assistance, and although most of this assistance has been received on concessional terms, foreign debt service payments will become a burden on the balance of payments with the progressive expiration of grace periods. In addition, continued expansion of trade with other socialist countries may give rise to a situation in which exports to countries in the convertible area are not sufficient to accommodate an adequate level of imports from that area and to make debt service payments in convertible currencies. The discussions, which were affected by the paucity of adequate statistical data, focused in particular on production and investment policies, domestic resource mobilization, export promotion measures, and external debt policies.

1. Production and investment policies

In addition to the reorganization of many government departments in 1983, the authorities have also re-evaluated the objectives of the Five-Year Plan (1981-85) with a view to bringing them more in line with the

kind of projects and programs Laos can implement. For the remaining period of the Plan, the Government will direct the development effort toward implementation of small-scale projects that can be managed with relative ease and that are quick-yielding. The number of large scale projects has been reduced to two--the completion of Route 9 to Danang, which will reduce Laos' dependence on Bangkok as its main seaport, and the construction of an oil pipeline to Viet Nam. In an important departure from previous policies, the authorities also decided to encourage cooperation with the private sector, in particular in the areas of distribution and transportation.

As the stagnation in foodgrain production during 1982 and 1983 underscored again the vulnerability of the economy to adverse weather conditions, the major objectives of the authorities continue to be consolidation of self-sufficiency in food, a further rise in per capita consumption of cereals, and diversification of agricultural production. However, despite its large potential, further growth of the agricultural sector will be limited by a number of constraints. Due to the lack of investment resources, as well as manpower and draft animals in some areas, the area under cultivation is unlikely to grow by more than 2 percent a year and may actually decline if the Government is successful in curbing slash and burn techniques, which now account for about 30 percent of total rice production. ^{1/} Attempts to raise agricultural yields through better technology will have to concentrate mainly on the extension of the area that can be irrigated and the provision of agricultural support services. However, the present agricultural extension system reaches only a small proportion of the farmers and, mainly because the design capacity of the Ministry of Irrigation is limited, the annual increase in the area that can be irrigated is estimated at not more than 3,000 hectares; less than 0.5 percent of the total area under cultivation. Moreover, shortages of spare parts and electric power, as well as a lack of tradition for irrigated cultivation has meant that a considerable proportion of irrigated land remained unused in recent years.

In view of these constraints, the authorities believe that remunerative procurement prices and adequate supplies of consumer goods are essential for stimulating agricultural output, in particular through double cropping and cultivation of cash crops. During the course of 1983, the system whereby procurement prices are negotiated with the farmers was extended to cotton, maize and pork, and, in particular for rice, negotiated prices were permitted to reflect more closely prices

^{1/} Under slash and burn techniques farmers burn down sometimes valuable tracts of forest to make room for the cultivation of rice. Because of the rapidly deteriorating condition of the soil, these tracts of land are seldom cultivated for more than three years.

in the free market. In order to improve the procurement and distribution of food products, a newly created Food Corporation has recently taken over these functions from the State Trading Corporation. 1/

As part of its policy to achieve and maintain self-sufficiency in food, the Government has announced its intention to establish foodgrain stocks at 50 percent of annual consumption. Because such a level of stocks is rather high compared with international standards or in relation with the estimated variability of 15 percent in foodgrain production in Laos, the authorities are currently reconsidering this objective. The establishment of a smaller buffer stock would free resources for the improvement of transport facilities, especially feeder roads, which, in turn, would permit easier trade between surplus and deficit areas.

The authorities believe that training of cooperative management should precede further collectivization of agriculture. The collectivization is being organized in three stages: (1) organization of production solidarity teams, (2) the establishment of collective ownership of agricultural equipment, and (3) the establishment of collective ownership of the land. About 20-25 percent of the farmers, mainly in the northern part of the country, are believed to have been organized in production solidarity teams. The authorities have not set themselves a target date by which collectivization of the agricultural sector should be achieved, and the participation of the farmers in cooperatives will remain voluntary.

Laos' forests are probably its most valuable natural resource. Excluding inaccessible areas and forest of marginal value, the exploitable forest surface is estimated at between 3 and 7 million hectares, permitting a production of up to 6 million cubic meters per year. By comparison, annual production has been about 150,000 cubic meters in recent years. Major constraints on the development of forestry include difficulties of access and egress, lack of felling equipment and trained supervisory personnel and, despite an increase of 200-400 percent in 1981, procurement prices that are barely covering logging costs. Since the State Trading Corporation was given a monopoly over timber exports in 1981, exports have steadily declined, mostly because of inexperience in foreign marketing. As part of a reorganization of the procurement and export of wood and forestry products, a new company, the Lao Corporation for Wood Commercialization, was established in 1982. The corporation has been charged with the improvement of quality control, the classification of various types of timber according to international standards, and the negotiation of adequate prices for the export of timber. The Government is still considering an offer by a major donor, made in 1982, to provide expertise in the international marketing of timber.

1/ The State Trading Corporation was created in 1981. All state trading activities, including food procurement and distribution, were brought under its control.

The development of industries is constrained by the fragmentation of the domestic market, the physical separation of Laos from world markets, and shortages of trained manpower. The authorities therefore aim at improving capacity utilization of existing industries, particularly those that process domestic raw materials such as timber and agricultural products. A limited number of new enterprises will be established in the construction sector, but a 200,000 ton cement factory, which was to be constructed with aid from the Soviet Union, has been postponed indefinitely. The installation of a fifth generator at the Nam Ngum hydroelectric dam, now scheduled for 1985, will raise capacity from 110 to 150 MW. The Government has indicated its intention to encourage private production, but it has not made a policy statement on the conditions under which private industries may operate. Among other things, such a statement would probably alleviate some of the constraints caused by lack of technical and managerial skills.

2. Financial policies

Preparations for the 1984 budget had not yet been completed at the time of the discussions. The authorities indicated, however, that they expect domestic revenue to increase by 15 percent, largely because of the full year effect of the tax measures introduced on the private sector during the course of 1983. The growth in domestic revenue may be somewhat higher if these tax measures are made applicable to the public sector during the course of 1984. Except for the effect of the 50 percent increase in salaries granted to civil servants last September, current expenditures are slated to remain unchanged from 1983. In addition, government departments will be asked to meet a substantial part of the salary increase with funds from other expenditure categories. The authorities expect the overall deficit to be fully covered by foreign aid receipts. In case of shortfalls in either domestic revenues or foreign aid, they will seek a reduction in capital expenditure in order to avoid recourse to the banking system. Despite the small retrenchment during 1983, policies will continue to aim at increasing the public savings rate so that foreign financing of capital expenditure can be reduced.

In addition to keeping growth in current expenditure to a minimum, consideration is being given to an adjustment in the exchange rate used for the valuation of customs duties from K 10 per dollar to the commercial rate of K 35 per dollar. Aid-financed imports from the convertible area and all imports from the nonconvertible area are not subject to customs duties. The staff indicated that extending customs duties to these imports would not only enhance revenue but would also promote a better use of foreign aid.

During the course of 1983, the authorities took a number of measures to improve operational efficiency of public enterprises through greater autonomy and stricter controls of cost. Enterprises that meet certain criteria with regard to profitability, production, the use of working

capital, and transfers to the budget are now permitted to retain 40 percent of their profits; to set wages on the basis of productivity, hours worked and quality of output; and to retain 35 percent of their export earnings to meet their requirements for imported raw materials and spare parts. The authorities are also considering measures requiring the enterprises to maintain or increase their profits in real terms. To this end, inventories of physical assets in public enterprises have already been made and guidelines for the calculation of depreciation of capital on the basis of replacement cost, defined as historical cost adjusted by an index of inflation, are expected to be issued in 1984. Public enterprises may now also be given permission to sell their products directly to consumers at prices somewhat higher than the official prices or, if they have met their sales quota, at prices that are close to free market prices.

Although prices of consumer goods for civil servants and employees of public enterprises have been adjusted frequently, the distribution of four products--rice, sugar, fabrics and detergent--remains subject to subsidies. For instance, the price of rice for civil servants is K 3 per kilo compared with procurement cost of about K 10 per kilo and free market prices ranging from K 13 to K 45 per kilo, depending on location. After public enterprises received greater autonomy in the determination of wages during the course of 1983, the price of rice for their employees was raised from K 3 to K 6 per kilo, but due to higher cost for procurement, milling and distribution, the cost of the rice subsidy rose from the equivalent of 2.0 percent of GDP in 1982 to 2.2 percent in 1983. Prior to 1983, the cost of the subsidies was borne entirely by the State Trading Corporation, which financed them with profits from the distribution of other consumer goods and the exports of timber. However, in 1983 the Government made a provision in its budget to finance K 150 million, or about 40 percent of the total cost of the subsidies. It intends to assume the full cost of the subsidies in 1984, which will permit the trading companies to set prices for their other sales independently from the need to generate resources for the subsidies. The authorities intend to limit the size of the subsidies over the medium term through price adjustments and a tightening of eligibility rules.

Monetary policies are largely designed to accommodate price and wage developments in the public sector and to provide public sector enterprises with sufficient credit to meet the annual production targets of the Plan. The authorities indicated that the expansion of total liquidity during 1982 and the first half of 1983 had been excessive in part because of the inability of the National Bank of Laos to monitor the credit requirement of public enterprises. Credit had been extended in accordance with targets of the Plan rather than according to actual need, and enterprises had been reluctant to repay credits, preferring instead to increase their deposits. Studies have recently been initiated to determine criteria for a more selective credit policy that will take into account the liquidity and profitability of individual enterprises,

and their actual fulfillment of the Plan targets rather than the targets themselves. The staff team observed that, with the recent moves toward greater autonomy of public enterprises, the availability of liquid balances would become more important in economic decision-making at the unit level. More stringent criteria for the granting of credit would therefore be essential to avoid inflationary pressures. With the greater emphasis that has been placed on profitability, the introduction of severe penalty rates of interest for credits that are overdue would be one way of improving the cash management of public enterprises. The staff team also indicated that the relative importance of "other assets" in the consolidated balance sheets of the banking system suggested an understatement of credit that was actually extended. A better compilation of monetary and credit data would therefore strengthen the authorities' control over monetary developments and would permit a more accurate forecast.

Laos has traditionally maintained a policy of low interest rates; the most frequently used lending rate and the maximum deposit rate are both 7.2 percent per annum. The authorities indicated that a recently completed internal study had suggested an increase in interest rates up to a level of 15 percent per annum and that the Government would make a decision on this proposal during the course of 1984.

3. External policies

Despite the recent improvement of the current account, the external position has remained weak; 1983 marked the fourth year in a row in which the balance of payments with the convertible area incurred a deficit. The persistence of these deficits is largely attributable to the fact that, even with the tripling of the price of electricity sold to Thailand, exports to the convertible area have been growing at a much slower pace than those to the nonconvertible area. Official merchandise exports have been directed almost exclusively toward the nonconvertible area, either because of contractual obligations (coffee, tin) or because the quality of products finds a more ready market in countries of the nonconvertible area (handicrafts, clothing, plywood). By contrast, exports of logs--after electricity the most important earner of convertible foreign exchange--have declined from \$8.5 million in 1979 to \$3.0 million in 1983, largely because the authorities are reluctant to sell at prices they consider too low. The inventory of logs that has accumulated as a result of this policy is estimated at about 50,000 cubic meters with an export value of between \$15 and \$20 million.

The outlook for the balance of payments and external debt in the period ahead is a source of concern. Although aid and credits under bilateral payments agreements will probably continue to finance deficits on the current account with the nonconvertible area, transactions with the convertible area, including the payment of obligations to the Fund, are estimated to incur deficits of \$18 million in 1984 and \$16 million in 1985. Because of the low level of foreign exchange reserves and the

limited scope for foreign borrowing, deficits of these magnitudes cannot be financed. Therefore, in the absence of early measures to increase foreign exchange earnings, imports may have to be reduced starting in 1984. This, in turn, could seriously impede the further development of the economy, inter alia, by undermining the Government's policy to stimulate agricultural production by providing more consumer goods to farmers. Even if Laos were to obtain foreign loans to finance its balance of payments deficit in 1984 and 1985, the ensuing debt service burden in subsequent years would be unsustainable. (Table 4, Scenario A). In view of these prospects, the staff team suggested that the Government should make every effort to increase exports to the convertible area and that it should no longer insist on export prices that are not acceptable to foreign buyers. In addition, the acceptance of the expertise in the marketing and pricing of timber offered by a major aid donor should not be delayed further.

Due to the long and largely uncontrolled border with Thailand, part of Laos' foreign trade is conducted outside official channels by private traders and the provincial authorities. This trade has become more attractive in recent years as the result of the growing disparity between the commercial exchange rate and the exchange rate in the parallel market which recently reached K 120 per dollar. Although the preferential exchange rate of K 108 per dollar introduced last July has resulted in an increase in inward private remittances through the banking system, the bulk of these transactions is still channelled through the parallel market. The authorities agreed that, as the result of the rapid rise in domestic prices, the exchange rate had become overvalued since the 71 percent devaluation in early 1982 and that, in order to stimulate exports and attract more transactions into official channels, a further devaluation of the kip, coupled with an increase in official domestic procurement prices of exportable products, should be considered. However, they indicated that despite the urgency to improve the balance of payments, the extent of the devaluation would have to be circumscribed by the need to avoid large increases in official consumer prices.

At the end of 1982, total disbursed external debt amounted to \$342 million, equivalent to 105 percent of GDP. Of this amount, \$223 million was owed to the nonconvertible area and \$119 million to the convertible area. Most of the debt owed to countries in the convertible area was incurred for the financing of the Nam Ngum hydroelectric power project. Largely because of repurchases falling due to the Fund, the debt service ratio with respect to the convertible area is projected to rise from 20 percent in 1983 to 40 percent in 1984 and 1985 (Table 5). A reduction in debt service obligations and sharply higher exports of electricity from the Nam Ngum project are expected to bring the ratio down to 21 percent in 1986 and 17 percent in 1987. Although service payments to the nonconvertible area are still relatively modest, they are projected to rise rapidly, i.e. from \$1.5 million (6 percent of export earnings) in 1983 to \$3.0 million in 1986.

Table 4. Laos: Projections of Cash Transactions
with the Convertible Area 1/

(In millions of US Dollars)

	1982 Actual	1983 Estimate	1984	1985	1986	1987
			Projection			
<u>Scenario A 2/</u>						
Exports	26.9	27.7	30.5	37.8	54.2	58.9
Electricity	23.9	24.0	26.6	33.7	49.9	54.4
Timber	2.6	3.0	3.0	3.0	3.0	3.0
Other	0.4	0.7	0.9	1.1	1.3	1.5
Cash imports	-44.0	-45.0	-47.0	-50.0	-54.0	-57.0
Services 3/	9.0	8.8	9.0	10.0	11.0	12.0
Current account 3/	-8.1	-8.5	-7.5	-2.2	11.2	13.9
Cash aid	5.0	7.0	2.0	1.0	--	--
Debt service payments	-4.5	-5.5	-12.1	-20.6	-22.6	-21.4
<u>New borrowing</u>	--	--	17.6	21.8	11.4	7.5
Overall balance	-4.1	-5.5	--	--	--	--
Debt service ratio	17	20	40	55	42	39
<u>Scenario B 4/</u>						
Current account 3/	-8.1	-8.5	10.1	14.1	11.2	13.9
Of which: Cash imports	-44.0	-45.0	-29.4	-33.7	-54.0	-57.0
Cash aid	5.0	7.0	2.0	1.0	--	--
Debt service payments	-4.5	-5.5	-12.1	-15.1	-11.2	-10.2
Overall balance	4.1	-5.5	--	--	--	3.7
Debt service ratio	17	20	40	40	21	17

Source: Data provided by the Lao authorities and staff estimates.

1/ Excluding imports financed with aid. The projections are based on unchanged export policies.

2/ Balance of payments deficits financed with new borrowing. It is assumed that the financing will be in loans of 5 years maturity and at an interest rate of 12 percent.

3/ Excluding interest.

4/ Reduction in imports.

Table 5. Laos: External Debt Service Projections 1/

(In millions of U.S. dollars)

	1983	1984	1985	1986
<u>Total Debt service</u>	<u>7.01</u>	<u>14.08</u>	<u>17.46</u>	<u>14.25</u>
Capital	3.21	10.77	14.16	11.50
Interest	3.80	3.31	3.30	2.75
<u>Multilateral loans</u>	<u>4.05</u>	<u>9.95</u>	<u>12.92</u>	<u>8.08</u>
Capital	1.08	7.56	10.51	6.18
(IMF) <u>2/</u>	--	(6.09)	(8.98)	(4.65)
Interest	2.97	2.39	2.41	1.90
(IMF) <u>3/</u>	0.98	(0.89)	(0.46)	(0.10)
<u>Bilateral loans</u>	<u>2.96</u>	<u>4.13</u>	<u>4.54</u>	<u>6.17</u>
Convertible area	1.46	2.14	2.13	3.16
(Capital)	(0.63)	(1.22)	(1.24)	(2.31)
(Interest)	(0.83)	(0.92)	(0.89)	(0.85)
Nonconvertible area	1.50	1.99	2.41	3.01
(Capital)	(1.50)	(1.99)	(2.41)	(3.01)
(Interest)	--	--	--	--
Debt service ratio with convertible area <u>4/</u>	20	40	40	21

Source: Data provided by the Lao authorities and the staff.

1/ Debt service payments for 1984, 1985 and 1986 are for debt outstanding at the end of 1983.

2/ Repurchase obligations to the Fund and repayments of Trust Fund loans.

3/ Fund charges.

4/ Based on scenario B in table 4.

The practice of converting deficits under bilateral clearing arrangements into long term loans at the current annual rate of about 3 percent of GDP will lead to a further rise in the debt service burden to CMEA countries during the late 1980's and the 1990's. The Lao representative mentioned that, except for possible balance of payments financing, they would continue to avoid borrowing in maturities of less than 5 years, and that longer-term loans would be contracted only if they contained a highly concessional element. Henceforth, before foreign financing of particular projects is authorized, the authorities will also take into account their potential contribution to the balance of payments.

The exchange and trade system remains highly restrictive and bilateral payments agreements are maintained with the USSR, Bulgaria, Czechoslovakia, the German Democratic Republic, and with two Fund members, Viet Nam and Hungary. The introduction of a preferential exchange rate of K 108 per dollar for inward private remittances constitutes a multiple currency practice requiring approval under Article VIII.

IV. Staff Appraisal

The Lao economy remained stagnant in 1982 and 1983 as further growth of the agricultural sector was affected by dry weather and a halt in the reclaiming of arable land, a major factor in the growth performance of previous years. However, rice availability remained sufficient and, despite shortages of inputs, industrial output continued to expand. Although new taxes were introduced in the private sector during 1983, revenue growth remained behind that of current expenditures, resulting in a decline in public savings. A rapid monetary expansion contributed to a rise in inflation and, for the fourth year in a row, the balance of payments registered a deficit in 1983. Convertible foreign exchange reserves have fallen to about three weeks of imports from the convertible area.

As possibilities for extending the area under cultivation have become more limited, further gains in agricultural output will have to come increasingly from yield-increasing techniques and the cultivation of cash crops. Because of the lack of technical manpower, appropriate extension services, and modern agricultural inputs, the authorities are relying on remunerative procurement prices and adequate supplies of consumer goods as incentives to raise and diversify agricultural output. To this end, the system of negotiated procurement prices has been extended to a number of cash crops and negotiated prices for rice have been permitted to reflect more closely the prices on the free market.

The recent establishment of a Food Corporation is expected to lead to a more efficient procurement and distribution of food products. Although, due to variable weather, the economy is particularly vulnerable to fluctuations in agricultural output, the staff believes that the Government's objective of establishing a food reserve equal to six months of consumption should be reconsidered, both in terms of actual need and possibilities to expand trade between food deficit and surplus areas through improvement of the road system.

In view of the heavy dependence on foreign aid and the urgent need to improve the basic infrastructure, domestic resource mobilization should continue to receive high priority in the years ahead. The staff welcomes the intention of the authorities to keep the growth of current expenditures to a minimum. However, additional measures to increase public savings, such as the adjustment in the customs valuation rate,

which has been under consideration for some time, and the extension to the public sector of the tax measures introduced for the private sector in 1983, should no longer be delayed. The imposition of duties on aid-financed imports from the convertible area and on all imports from the nonconvertible area would not only enhance revenue but would also provide for a better use of foreign aid. The greater autonomy provided to public enterprises with regard to prices, wages, investments and imports should contribute to greater efficiency and an increase in profitability.

A slowing of the growth rate of monetary aggregates will be essential for a reduction in inflationary pressures. To this end, the adoption of more stringent credit policies will have to be a necessary adjunct to the greater autonomy that has been granted to public enterprises. In addition, monetary policy and the control over the cash management of public enterprises could benefit from a more rational and timely compilation of monetary statistics. A rise in interest rates, on which a decision has been scheduled for 1984, should contribute to a more efficient use of capital resources.

With foreign exchange reserves at a low level and limited possibilities to obtain foreign financing, the outlook for the balance of payments is not viable. In the absence of adequate policy measures, shortages of foreign exchange are expected to be a major constraint on the economy in the period immediately ahead. Considering the urgent need to raise foreign exchange earnings from the convertible area, export promotion measures appear to fall considerably short of what is feasible and desirable. In addition, the external value of the kip has been eroded by domestic inflation subsequent to the exchange rate adjustment of early 1982. The staff believes that the adoption of flexible export prices and a substantial adjustment of the exchange rate are essential for an improvement in the balance of payments and the future growth performance of the economy, and that appropriate measures in these areas should be adopted without delay. The adoption of a more active exchange rate policy would be consistent with the greater price flexibility that has recently been introduced in many sectors of the Lao economy. The staff does not recommend approval of the multiple currency practice that arises from the preferential exchange rate for inward remittances that was introduced in July 1983.

It is recommended that the next Article IV consultation with Laos be held on the standard 12-month cycle.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to exchange measures of the Lao People's Democratic Republic subject to Article VIII, Sections 2 and 3, and in concluding the 1983 Article XIV consultation with the Lao People's Democratic Republic in the light of the 1983 Article IV consultation with the Lao People's Democratic Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that the Laotian exchange system remains restrictive and involves a multiple currency practice described in SM/84/30. The Fund encourages the authorities of the Lao People's Democratic Republic to terminate the multiple currency practice as well as the bilateral payments arrangements with Fund members.

Fund Relations with Laos
(As of December 31, 1983)

Membership:	1961.
Status:	Article XIV.
Quota:	SDR 24 million.
Proposed quota:	SDR 29.3 million
Fund holdings of kip:	153.9 percent of quota, of which 53.9 percent on account of regular facilities.
SDR position:	SDR holdings amounted to SDR 0.13 mil- lion or 1.46 per cent of total cumu- lative allocation of SDR 9.41 million.
Trust Fund loan disbursements:	SDR 5.39 million (first period) and SDR 7.32 million (second period).
Direct distribution of profits from gold sales:	\$1.23 million.
Gold distribution:	11,125.533 fine ounces.
Exchange rates:	The official exchange is K 10 per US\$1, but no transactions take place at this rate. A commercial rate of K35 per \$1 applies to all transactions, with the exception of inward private remittances for which a rate of K108 per \$1 was introduced in July 1983. The rate of K 10 per US\$1 is used for customs valuation purposes only.
Representative rate:	K 10 per US\$1.
Article IV consultation:	The last Article IV consultation was held in August/September 1982 (SM/82/214 and SM/82/218); the Executive Board discussed the staff report on December 8, 1982.

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World Bank Group Operations in LaosSummary

	<u>Project Status</u>	<u>Date of Approval</u>	<u>Source of Financing</u>	<u>Purpose</u>	<u>Amount US\$ mn.</u>
1.	Approved	January 1978	IDA	Agricultural rehabili- tation and development	8.2
2.	Approved	June 1979	IDA	Agricultural rehabili- tation and development	10.4
3.	Approved	April 1980	IDA	Agricultural rehabilita- tion and development	13.4
4.	Approved	December 1981	IDA	Extension of Nam Ngum Dam	15.0
5.	Approved	June 1983	IDA	Agricultural production support	6.2 <u>1/</u>

The Bank group and the Government are presently discussing the types of assistance Laos will need in the future. Among the projects being discussed are: rural electrification in the southern provinces; industrial rehabilitation, focusing particularly on timber processing for exports; and support for high-priority inputs to facilitate the agricultural development program.

1/ This project is co-financed by IDA, IFAD, and UNDP. The total cost is estimated at \$24.8 million. The share of IDA would be \$6.2 million.

LAOS

Basic Data

Area and population

Area	236,800 square kilometers
Population (estimated 1982)	3.9 million
Annual rate of population increase	2.4 percent

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u> <u>Est.</u>
<u>GDP (at current prices; in millions of kip)</u>	5,255	7,752	11,403	18,047
<u>GDP per capita (US\$)</u>	100	91	83	128
<u>Output (percentage change)</u>				
Real GDP	10.0	5.0	-1.0	1.0
Production of rice	21.5	9.6	-5.4	1.8
Gross industrial production	...	-0.4	4.8	2.9
Of which: electricity	-0.3	-5.7	9.2	--
<u>Prices (percentage change)</u>				
Consumer price index (end of period)	62.3	23.1	40.8	62.6 1/
Official prices	1.9	--	52.0	28.1 1/
Free market prices	117.1	32.9	37.2	576.1 1/
GDP deflator	48.7	40.6	48.6	556.7
<u>Budget (percentage change)</u>				
Revenue	179.2	32.2	178.6	26.9
Expenditures	179.4	10.1	179.9	22.3
Current	161.0	--	119.7	30.4
Capital	209.3	23.9	246.5	16.6
<u>Monetary survey (percentage change)</u>				
Domestic credit	99.3	25.1	23.4	33.0 1/
Of which: credit to public enterprises	(181.9)	(29.9)	(24.4)	(31.9) 1/
Total liquidity	163.9	3.5	52.7	48.9 1/
Cash in circulation	57.0	7.6	39.6	19.0 1/
<u>Balance of payments (in millions of US\$)</u>				
Official exports	13.5	19.4	39.8	52.3
Convertible area	13.5	14.0	26.9	27.7
Of which: electricity	(5.3)	(7.9)	(23.9)	(24.0)
Nonconvertible area	...	5.4	12.9	24.6
Official imports	-92.3	-90.2	-124.2	-125.0
Convertible area	-42.0	-36.2	-44.0	-45.0
Nonconvertible area	-4.7	-13.8	-30.2	-40.0
Under aid programs	-45.6	-40.2	-50.0	-40.0
Trade balance	-78.8	-70.8	-84.4	-72.7
Current account	-81.1	-70.1	-78.9	-67.7
Capital and transfers (net)	66.6	73.4	80.2	62.2
Overall balance	-11.0	-5.8	-4.1	-5.5

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LAOSBasic Data (concluded)

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u> <u>Est.</u>
<u>International reserves</u> (in millions of US\$)				
Gross international reserves	14.04	13.53	8.54	8.10 <u>2/</u>
(In months of imports)	(1.8)	(1.8)	(0.8)	(0.9) <u>2/</u>
(In months of non-aid imports from the convertible area)	(4.0)	(4.5)	(2.3)	(2.2)
Net international reserves	3.07	-1.49	-5.55	-5.99 <u>2/</u>
<u>External debt operations</u> (in millions of US\$)				
External debt outstanding (disbursed)	265.9	312.4	342.5	385.0
Of which: convertible area	(...)	(110.0)	(120.0)	(125.0)
External debt servicing	3.1	4.4	6.1	7.0
Of which: convertible area	(3.1)	(4.4)	(4.5)	(5.5)
<u>Exchange rate</u> (end of period; kip per US\$)				
Official	10	10	10	10
Commercial	10-15	30	35	35
Inward remittances	--	--	--	108
Free market	24	60	105	120
<u>Selected ratios to GDP</u> (percent)				
Budget revenue	14.2	12.8	24.1	19.4
Budget expenditure	33.8	25.2	48.0	37.1
Overall budget deficit	-19.6	-12.4	-23.9	-17.7
Domestic revenue minus current expenditure	-5.3	-0.5	4.3	3.1
Total liquidity	14.6	10.3	10.6	7.6 <u>2/</u>
Cash in circulation	3.0	2.2	2.1	1.5 <u>2/</u>
Official exports of goods	3.6	5.5	12.2	10.1
Official imports of goods (-)	-24.6	-25.6	-38.1	-24.2
Current account deficit (-) of balance of payments	-21.6	-19.9	-24.2	-13.1
Overall balance of payments deficit (-)	-2.9	-1.6	-1.3	-1.1
External debt outstanding (disbursed)	70.9	88.7	105.1	74.7
External debt servicing	0.8	1.2	1.9	1.4

1/ June 1983 over June 1982.2/ Outstanding in June 1983.

