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EBS/02/129
Correction 1

CONFIDENTIAL

August 23, 2002

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Lao People's Democratic Republic—Staff Report for the 2002 Article IV Consultation, Second Review Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria**

The attached corrections to EBS/02/129 (7/15/02) have been provided by the staff:

Page 6, para. 3, line 3: for "1997–99." read "1998–99."

Page 12, Box 2, para. 5, lines 1 and 2: add to read "(i) implementation of a development framework;" and subsequent sub-paragraphs renumbered

Page 21, line 1: for "political climate," read "political and social concerns about rapid transformation,"

Questions may be referred to Mr. Winglee (ext. 35693) and Mr. Q. Hussain (ext. 37334) in APD.

Att: (3)

Other Distribution:
Department Heads

EXECUTIVE SUMMARY

- **Over the past 15 months Lao P.D.R. has made substantial progress under the PRGF-supported program**. Inflation remains relatively low at 6½ percent and the exchange rate fairly stable. Progress at reforms has stimulated investment, and real GDP growth in 2002 is estimated at 5½ percent.

- **Program implementation has been effective and the program remains broadly on track**. Expenditure restraint has limited the impact of the revenue shortfall on bank financing of the budget. In particular, tight control of central bank financing of the budget slowed liquidity growth and enabled the international reserve target to be achieved.

- **All quantitative performance criteria were met except for the net domestic assets (NDA) of the state commercial banks (SCBs)**. The latter was partly due to irregular credit operations that are being corrected. Structural targets under the program were generally implemented, although with some delays, including the structural performance criterion related to SCB provisioning on post-2000 nonperforming loans. However, the medium-term plan for public expenditure management reform has been postponed until the third review.

- **On the macroeconomic side, the program for 2002–03 consolidates stabilization efforts**. Revenue efforts will need to be reinvigorated and expenditure will be constrained to achieve the deficit and bank financing limits for 2001/02. For the next fiscal year, the government will undertake further restructuring and strengthening of the tax and customs departments and make progress in identifying education and health expenditures. Regarding the monetary program, BOL liquidity creation will remain tightly controlled and strong measures will be taken to limit state bank credit growth to offset some of the slippages in the early part of 2002.

- **On the structural side, the phased banking and enterprise reforms are underway**: (i) **Banking reform** has been initiated with measures to improve performance. In addition, plans have been developed which include the effective liquidation of the weakest bank, bi-annual performance tests, bank advisors, and branch and staff rationalization. (ii) **SOE reform**, which covers the largest and most indebted enterprises, has also begun. Management contracts, joint ventures, asset sales, and price adjustments are being used to improve SOE operations. (iii) **For the private sector**, the authorities will continue implementing the successful measures to improve the environment for foreign and domestic investment.

- **The next stage of the banking and enterprise reforms will be the most challenging** and strong political commitment will be required for their full implementation.

- **Steady progress has been made in developing the PRSP** and sharpening the poverty focus of the program.

I. Introduction

1. **At the conclusion of the first review under the PRGF (in February 2002) and the 2001 Article IV Consultation (in April 2001), Directors commended the authorities for reducing inflation**, strengthening fiscal discipline, and laying the groundwork for further structural reforms. However, they noted that fiscal imbalances remained and called for taking strong revenue measures, establishing an information base for tracking poverty-related expenditures and improving accountability at all levels of government. Directors also urged the authorities to step up the pace of structural reform. In particular, they noted the continued weakness of the banking system and stressed the need to move ahead decisively with reforms, contain credit growth, reduce nonperforming loans, upgrade banking supervision, and initiate state-owned enterprise (SOE) restructuring, especially for the largest debtors.

2. **Over the past year, the Lao authorities have made substantial progress at strengthening macroeconomic stability and initiating a broad-based reform program**. In the attached letter dated July 8, 2002, and the accompanying Memorandum of Economic and Financial Policies (MEFP), the authorities request the completion of the second review under the PRGF, and request waivers for the nonobservance of two performance criteria for March and April 2002.[1] The World Bank approved the Financial Management Adjustment Credit (FMAC) on June 25 that addresses reforms to state-owned commercial banks (SCBs), SOEs, and public expenditure management. The government is close to agreement with the AsDB on a new Financial Sector Program Loan (FSPL3).

II. Recent Developments and Performance Under the Program

Recent developments and short-term prospects

3. **Economic performance has improved considerably since late 1999**. Starting in mid 1999, the authorities tightened macroeconomic policies after inflation rose to triple digits in 1998–99. The firm implementation of these policies quickly brought down inflation and stabilized the exchange rate. Since then, economic conditions have generally been favorable. A rekindling of business confidence and continued aid inflows helped to offset the negative impact of weaker regional growth in 2001, with real GDP growth weakening only slightly to 5¼ percent. Recent anecdotal evidence suggests that the pick-up in regional activity, new small-scale construction, and foreign investment should sustain real GDP growth in 2002 at about 5½ percent (5 percent projected previously) (Table 3). In particular, ongoing reforms to

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[1] With a third disbursement (SDR 4.6 million) Lao P.D.R.'s outstanding use of Fund resources will amount to SDR 34.7 million (65.7 percent of quota) at end-July 2002. Assuming full disbursement under a revised schedule for the PRGF Arrangement (Table 1), Lao P.D.R.'s outstanding use of Fund resources would amount to SDR 38.4 million (72.5 percent of quota) at end-2004 (Table 2).

III. Report on the Discussions

A. Medium-Term Policy Objectives and Framework

8. **In the context of recent success at macroeconomic stabilization, the Article IV and program discussions provided an opportunity to take a medium-term perspective on reform**. This timing coincided with the government's own review of its economic reform strategy, as part of its National Poverty Eradication Programme (NPEP) that is expected to be finalized by early 2003.[6] This program, intended to meet the requirements of the PRSP, is the first stage in implementing the government's ambitious goal of exiting from least developed country status by 2020. The planned reforms entail restructuring the state sector to improve its efficiency, and attracting private domestic and foreign investment, as well as more effectively developing infrastructure and human resources with improved fiscal management and expenditure systems. In addition, the NPEP also addresses sectoral constraints in agriculture, education, health, and infrastructure.

9. **A key medium-term issue relating to the NPEP and the design of the reform program is the size of the state's role in the economy**. In this regard, the authorities pointed to the reforms of the early 1990s in which the bulk of the state sector was privatized, leaving state enterprises with a small share of the economy. In addition, they recognized that to meet the competitive challenges of regional integration, the role of the private sector, especially foreign investment, will need to be further increased and the poor financial performance of the state sector corrected. However, the authorities could not accept a rapid transformation, noting their limited capacity and their desire to first correct the most severe problems in the state sector themselves. Nevertheless, the government stated explicitly that from now, persistently loss-making SOEs will be privatized or liquidated and have started in this direction.

10. **The implementation of pro-growth economic policies is expected to raise real GDP growth to 6½ percent by 2004**. The authorities understand that this will depend on attracting domestic and foreign private investment. Reforms to Lao Aviation, and improved telecommunications and infrastructure are relieving major blockages to the tourism sector, and the construction of Nam Theun 2 (NT2) hydroelectric project would also add to growth starting in 2004 (Box 2). Continued strong stabilization policies are expected to reduce inflation further to 5 percent or below by 2004. Over the medium term, the government intends to keep the budget deficit (including grants) at about 4½–5 percent of GDP, with progressively increasing revenue to fund social spending and limit the use of bank financing (Table 7).

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[6] The delay from August 2002 envisaged in the I-PRSP is due to capacity limitations and the need to build up a participatory approach.

Box 2. Lao P.D.R.: Nam Theun 2 Hydroelectric Project

The Nam Theun 2 (NT2) hydroelectric project is a Build-Own-Operate-Transfer (BOOT) arrangement between the Government of Lao P.D.R. (GOL) and a private sector consortium, NT2 Electricity Consortium (NTEC). Situated in central Laos, 250 km east of Vientiane, the NT2 plant is now scheduled to begin construction in 2004 and supply electricity by 2008. The project will have a capacity of 920 megawatts for export to Thailand and an additional 75 megawatts for domestic consumption.

The total investment of US$1.1 billion will be financed through foreign direct investment, comprising debt (70 percent) and equity (30 percent). The NTEC consortium for this limited recourse project comprises Electricité de France (EDF) holding 35 percent, Electricity Generating Company of Thailand (EGAT) 25 percent, and Italian-Thai Development 15 percent. The GOL equity share will be 25 percent.

The Power Purchasing Agreement (PPA) was initialed in February 2002 by EGAT and the GOL. Under the PPA, EGAT would buy the 920 megawatts at 1.57 baht (3.65 cents at current exchange rates) per kWh or around 11 billion baht ($220 million) per year over the 25-year contract term. Revenues to the government should average about US$81 million per year over the 25-year period. Under the financial arrangements, GOL's share in revenues will be significant but back loaded. After about 10 years the GOL share would be 25 percent ($55 million) and would rise sharply thereafter, to 47 percent of the cumulative revenues by the end of the concession period (2033). Subsequently, the project would be transferred to the GOL, which would then retain 100 percent of revenues. During the construction period, the project is expected to add as much as one percentage point to real GDP growth per year.

The government's exposure to financial risks would be limited to its equity stake. The main financial risks to the project are commercial. They stem from cost overruns (contingencies allow for an extra 20 percent) and the credit and exchange risks under the PPA offset by the consortium's plan to borrow half the funds in baht. Of the GOL's $83 million equity stake, about ½–⅔ would be covered by grants from the partners for the development rights and the project preparation costs. At this stage, the only borrowing for the equity would be from the World Bank to cover the social and environmental costs.

The World Bank has indicated that its participation in the project would depend on: (i) implementation of a development framework; (ii) the quality of the project itself; (iii) social and environmental safeguards; and (iv) support from international donors and civil society. Under one scenario, the World Bank would provide between US$50–100 million in partial risk guarantees and a further IDA loan of between US$20–30 million to address the social and environmental impact. The government would provide a counter-guarantee for the partial risk guarantee, resulting in a government liability for this amount only if public policy actions prevent the operation of the project. The Bank considers that the main justification for participation in the project is to create an income stream that can be used for poverty reduction. The financial management reforms underway are an integral part of the strategy.

Important safeguards are expected to be in place to ensure that the social and environmental impacts are addressed. Several independent studies have highlighted the positive impact of the project including the avoidance of environmentally damaging traditional practices. Two panels have worked on these issues, a World Bank-sponsored International Advisory Group (IAG) and a GOL-appointed panel of social and environment experts. Both have broadly supported the NT2 project. However, other groups (especially NGOs) have voiced concern on its likely impact, including on the impact on the downstream communities and environment.

time, given the weak regulatory framework and political and social concerns about rapid transformation, commercialization is the precursor to any additional reforms.[14]

- **Restructuring first, and then phasing in participation of the private sector**: Lao Aviation is being restructured under a management contract with Air France Consulting, and this is expected to lead to Lao Aviation forming a joint venture to obtain additional capital for upgrading its aircraft fleet. This would follow the pattern of joint ventures for Lao Brewery and Lao Tobacco. The defense ministry conglomerates, first Phoudoi, and then DAFI, which are among the largest debtors to the SCBs, will be restructured through sales of noncore assets to reduce their debts, and commercializing their main service functions. The staff stressed the importance of asset sales, with highest priority given to assets in commercial sectors is to repay their bank debt.

24. **The authorities are also implementing policies to promote the private sector**. They recognize that a predominantly private sector economy is needed to be competitive. While private investment is being introduced gradually to SOEs, it is being strongly encouraged in new projects. Additional measures for private investment, which entail simplifying the environment for domestic enterprises and strengthening the credit environment, will be supported by the AsDB in FSPL3.

Trade and exchange system reform

25. **The authorities recognize that reforms to the trade and exchange system are also key for developing the private sector**. Over the past year, import controls have been somewhat liberalized and made more consistent with international practice to improve access of businesses to inputs. Thus, although importers still prepare indicative plans, only six product groups are now subject to quantitative restrictions and two of these products are expected to be liberalized before end 2002 (see MEFP paragraph 20). In addition, liberalization under AFTA is continuing and the first meeting of the working group for Lao P.D.R.'s membership to WTO was recently convened. A reduction in barrier to Lao exports in industrial country markets would also help growth.

26. **The authorities are committed to maintaining a liberal foreign exchange regime**. The Lao authorities consider that the system is free of restrictions on current international payments and transfers, and will preserve this under the new Foreign Exchange Decree Law (expected later in 2002) and the implementing regulations. The small margin between the bank and parallel exchange rates seems to confirm the absence of significant restrictions. The staff

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[14] The FMAC, which covers one year, includes mainly restructuring. This would pave the way for the joint ventures announced by the government that would be included in subsequent PRSCs.

welcomed these intentions and the absence of surrender requirement. When the new legal framework is close to completion, the authorities will request an assessment of their exchange system by Fund staff on the existence of restrictions on current transactions. On the basis of this assessment the Lao authorities will consider formally accepting the obligations under Article VIII.

D. Poverty and Social Impact

27. **The reforms supported by the PRGF will have a positive social impact by reducing poverty through promoting growth and raising human capital**. The World Bank is planning a comprehensive poverty and social impact analysis (PSIA) in 2004, with component studies in 2003. In the meantime, several aspects support a positive poverty assessment. Improvements in the macroeconomic environment have stimulated business and commercializing the SCBs should result in additional credit to small and medium-size borrowers. Newly available budget expenditure data show an increasing share to education and health at the expense of administration. The negative impact on the poor and low-income households from utility tariff adjustments, especially for electricity and water, will be mitigated by lower increases for small users. A social safety net is included in the banking and enterprise reforms, and a social fund that will support community-based projects was recently approved by the World Bank.

IV. Program Risks, Monitoring, and Safeguards

28. **Program implementation risks remain substantial**. The next stage of the reforms, including more stringent financial management, commercially based lending, enforcement of repayments, and staff reductions in the SCBs and SOEs, will present significant political challenges. So far the positive response of private investment to the first round of stabilization and reform measures is encouraging the authorities to pursue this reform agenda. Coordinated monitoring by the World Bank, AsDB, and Fund will be important to ensure that the reform program remains on track.

29. **The authorities are requesting waivers for the nonobservance of one end-March 2002 quantitative performance criterion and one end April 2002 structural performance criterion**, and the elimination of a structural performance criterion for end October 2002. In particular:

- The waiver for the nonobservance of the performance criterion on the net domestic assets of the SCBs is requested on the basis of the BOL's implementation of measures in paragraph 16 and the stabilization of the level of NDASCB in May.

- The waiver for the nonobservance of the structural performance criterion on banking supervision for full provisioning of post 2000 lending is requested on the relatively short delay (one month) in taking action, with the restatement of the SCB's 2001 accounts as a prior action that has now been implemented.