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November 12, 1982

To: Members of the Executive Board
From: The Secretary
Subject: Lao People's Democratic Republic - Staff Report
for the 1982 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation with the Lao People's Democratic Republic. A draft decision appears on page 16.

This subject has been tentatively scheduled for discussion on Friday, December 3, 1982.

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INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

Staff Report for 1982 Article IV Consultation

Prepared by the Staff Representatives for the
1982 Article IV Consultation with Laos

Approved by Hubert Neiss and Donald K. Palmer

November 12, 1982

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I. Introduction

A mission consisting of Messrs. Evers (ASD, Head), Pownall (ETR), and Rommel, Ms. Palanza, and Miss Lee (Secretary)(all ASD), visited Vientiane in the period August 21-September 2, 1982. The mission had discussions with Mr. Sithphasay, Vice Minister of Finance, and officials of the Ministry of Finance, the National Bank of Laos, the State Planning Commission, the Ministry of Trade and Industry, and the Bank for External Trade.

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

II. Background to the Discussions

Many of the adverse conditions that affected the economy during the years immediately following the war, including unfavorable weather, difficulties in reclaiming abandoned agricultural land, and rigid pricing policies, were reversed or overcome during the period 1979-81. Attempts to reclaim cultivable land met with considerable success, particularly in 1979, when the area under cultivation increased by 19 per cent. In addition, toward the end of 1979, the Government decided to depart from previous policies that emphasized controls, and to rely more on the market mechanism to promote production. Farmers were permitted to sell their products on the free market, many restrictions on private internal and border trade were lifted, and, as part of a broader move to reduce price distortions, official procurement prices for paddy and a number of other agricultural and forestry products were raised by about 300 per cent in December 1979.^{1/} As a result of these production-oriented policies and also because of favorable weather, agricultural output, after already having experienced a sharp increase in 1979, continued to expand rapidly in both 1980 and 1981. Rice production alone rose by more than 50 per cent between 1978 and 1981 and permitted the virtual elimination of food-grain imports. Real GDP rose by 10 per cent in both 1979 and 1980, and by 5 per cent in 1981. Mainly as the result of a drought that affected the lowland paddy crop last summer, total rice production may fall slightly in 1982 and the growth rate of GDP may level off to about 1 per cent. However, a resumption of large-scale imports of foodgrains is not expected.

Despite an improvement in the availability of food and a slowdown in monetary expansion, free market prices in the Vientiane area have continued to rise in both 1981 and 1982. The closure of the border with Thailand for a six-month period was an important factor in the rise in free market prices during 1981, while interruption in road transportation

^{1/} These policies were part of an economic program for the 12-month period ending May 1981, supported by a stand-by arrangement from the Fund for SDR 14 million or 58 per cent of quota.

to Vientiane and hoarding on the news of a poor summer rice crop led to a rise in food prices during the first half of 1982. The depreciation of the free market exchange rate for the kip, at which unofficial border transactions take place, contributed to the rise in domestic prices in both years.

The growing differential between official prices and free market prices during 1981 led the authorities to adjust official prices again in January 1982. Procurement prices of a number of agricultural and forestry products were either raised (rice, coffee, timber) or left to be determined by the free market (cardamom, sticklac and benzoin); the procurement price for rice was increased by 50 per cent. At the same time, the preferential exchange rate was moved from K 30 to K 35 per U.S. dollar and made applicable to all exchange transactions, including all official imports and exports that had previously benefited from the official rate of K 10 per U.S. dollar. For these transactions the applicable exchange rate depreciated by 71 per cent. With the exception of rice distributed to civil servants and employees of state enterprises, the effects of the higher procurement prices and the changes in the exchange rate system were fully reflected in higher official retail prices. Prices of some commodities, such as beer and cigarettes, were raised either to eliminate subsidies or increase profit margins. Laos does not compile price indices but the staff estimates that the rise in the cost of living in the Vientiane area may reach 100 per cent in 1982, compared with 55 per cent in 1981. Due to different consumption patterns and easier access to food supplies, increases in the cost of living in rural areas have probably been less pronounced than in Vientiane.

Budgetary performance has improved steadily in recent years (Table 1). Profit transfers to the Government have risen sharply as state enterprises were permitted to apply unchanged profit margins to much higher prices for intermediate and consumer goods. In addition to the effect of higher prices, tax revenue also rose because of an increase in economic activity, better tax collection procedures for both enterprises and individuals, and a sharp increase in the yield of the agricultural tax. The improvement in the fiscal performance also stemmed from the tripling, in October 1981, of the price of electricity exported to Thailand, the effect of stricter inventory controls by state enterprises, and expenditure restraint. No salary increase was granted in 1981, and the 50 to 70 per cent raise that was granted in April 1982 was substantially below the rise in the cost of living. Also, through attrition and the successful implementation of rural resettlement programs, the number of civil servants was reduced by 20 per cent in 1981. These and other expenditure control measures have mitigated the effect on expenditures of the change in the exchange rate and the higher official prices that came into effect last January; current expenditures are projected to rise by 120 per cent in 1982 compared with a rise of 178 in domestic revenue. Since 1979, the overall budget deficit has been financed entirely with foreign aid and, except for seasonal requirements, the Government has abstained from borrowing from the banking system.

Table 1. Laos: Budgetary Operations, 1979-82

(In millions of kip)

	1979	1980	1981	1982	
				Budget	Revised estimates
Revenue	268	748	989	1,190	2,755
State enterprises	185	568	713	876	2,255
(Operating surpluses)	(138)	(312)	(420)	(474)	(1,595)
Private sector	48	98	200	252	415
Other revenue	35	82	76	62	85
Expenditures	636	1,777	1,956	2,152	5,475
Current expenditure	394	1,028	1,028	1,053	2,259
Wages and salaries	114	270	200	200	280
Debt service	19	23	45	28	96
Materials and supplies	96	668	725	765	1,798
Capital expenditures	242	749	928	1,098	3,216
Overall deficit (-)	-368	-1,029	-967	-962	-2,720
Foreign loans and grants <u>1/</u>	354	1,033	967	962	2,720
National Bank	14	-4	--	--	--
Memorandum items:					
Rice subsidy <u>2/</u>	135	--	80	80	360
(As percentage of GDP)					
Revenue minus current					
expenditure	-5.0	-5.4	-0.5	1.8	3.6
Overall deficit	-14.7	-19.8	-13.1	-12.3	-19.7
Total expenditures	-25.4	-34.2	-26.4	-27.8	-39.7
Rice subsidy <u>2/</u>	-5.4	--	-1.1	-1.0	-2.6

Sources: Data provided by the Lao 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 by the State Trading Company.

Credit policies have tended to accommodate the rise in official prices, with the result that the expansion of total domestic credit slowed from 156 per cent in 1980 to 25 per cent in 1981 (Table 2). Consistent with a decline in net foreign assets, total liquidity rose by 4 per cent in 1981, compared with a rise of 164 per cent in 1980. The growth rate in monetary aggregates during 1981 was substantially less than the estimated growth rate in nominal GDP of 40 per cent. Factors that may account for the difference include the stability of prices in the public sector, where most of the liquidity is held, and indications that the relatively large circulation of foreign currency in Laos has increased further.

Table 2. Laos: Monetary Survey, 1979-82

(In millions of kip)

	1979 Dec.	1980 Dec.	1981		1982
			June	Dec.	June
Net foreign assets	-243	-446	-478	-524	-367
Domestic credit	351	899	1,098	1,125	1,130
Government (net)	59	55	15	18	7
Public enterprises	288	812	1,040	1,055	1,070
Private sector	4	32	43	52	53
Total liquidity	291	768	902	795	927
Currency in circulation	100	157	165	169	231
Demand deposits	187	601	727	616	687
Savings deposits	4	10	10	10	9
Other items (net)	183	315	282	194	164

Source: Data provided by the Lao authorities.

Mainly because of the effects of the temporary closure of the border with Thailand and reductions in imports of foodgrains, the deficit on the current account of the balance of payments fell from US\$103 million in 1980 to US\$92 million in 1981. Exports, which had fallen in 1980, recovered in 1981, mainly on account of items not affected by the border closure, i.e., higher sales of electricity to Thailand and increased shipments to the nonconvertible area through the Vietnamese port of Danang. In addition to the effects of the border closure, exports of timber and, to some extent, those of coffee and other exportable goods continued to

be affected by low domestic procurement prices. Imports from the nonconvertible area nearly tripled and compensated in part for the decline in imports from the convertible area. The overall balance of payments deficit in 1981 amounted to US\$5.8 million, and another deficit of US\$0.2 million was incurred during the first six months of 1982. At the end of June 1982, gross foreign exchange reserves amounted to US\$12.4 million, equivalent to about 1.2 months of imports. Foreign liabilities, which consist mainly of outstanding purchases from the Fund, amounted to US\$14.1 million at the end of June 1982.

III. Report on the Discussions

The main objectives of economic policy under the Five-Year Plan (1981-85), which was formally approved last March, are: (1) further development of agricultural and forestry production, so as to provide more food to the population, and increase the availability of export products; (2) improvement of the basic infrastructure, in particular with regard to existing bottlenecks in transportation and technical and managerial skills, and (3) further organization of the economy along socialist lines. Although the Plan contains a number of quantitative targets, e.g., an average annual growth rate of 7 per cent and an increase in export earnings of 240 per cent during the Plan period, the authorities indicated that these targets were merely indicative of the direction in which the economy was to be developed, the targets do not constitute a quantitative framework for policy formulation. Investment decisions are taken on the basis of technical and economic feasibility, and the availability of domestic and external financing resources. The investment plan contains only four new projects--an oil pipeline and a road to the port of Danang in Viet Nam, a cement factory, and the establishment of a national transport company. The road to Danang (Route 9), which is expected to reduce the country's dependence on Bangkok as its main seaport, is the only major new project on which work is currently in progress. The main emphasis of the investment effort so far under the Five-Year Plan has been the completion of ongoing projects, such as improvement of Route 13, which runs north-south and connects Laos' major cities, the construction and rehabilitation of feeder roads, and other low cost and quick-yielding projects in, or related to, the agricultural sector. About 40 per cent of total investments under the Plan will be made in the transportation and communications sector. The IBRD is in agreement with the basic approach of the Five-Year Plan, although not necessarily with its quantitative targets. The Bank is currently financing three agricultural projects and the extension of the hydroelectric power facilities. Projects that are under consideration for IBRD assistance include the adoption of high technology in agriculture, rural electrification, and industrial rehabilitation, particularly in timber processing. The authorities consider the organization of the economy along socialist lines a long-term goal, the attainment of which could take several decades.

Even partial implementation of the Five-Year Plan will require substantial amounts of foreign aid, not only for projects but also to finance technical assistance and imports of basic consumer goods and agricultural

inputs, such as fertilizer and insecticides. As the deficit on the current account of the balance of payments is already about one quarter of GDP, the discussions focused in particular on ways to promote exports.

1. Production policies

One of the more important targets under the Five-Year Plan is an annual production of paddy of between 1.2 and 1.4 million tons by 1985, an increase of between 8 and 26 per cent over 1981. Unlike recent years when the expansion of cultivated acreage contributed importantly to increased output, further gains are to come increasingly from the adoption of more intensive cultivation techniques such as irrigation and use of high-yielding varieties, fertilizers and insecticides, large increases in the total area under cultivation are not anticipated. Because intensive cultivation bears a greater risk for the farmer and requires a larger input of his labor, the increase in rice output will depend importantly on the success of policies aimed at providing adequate incentives. The authorities believe that the higher level of procurement prices in recent years and the introduction of a system whereby rice procurement prices are negotiated annually with the farmers according to cost and local scarcities have materially contributed to the expansion of output. Procurement prices will therefore be kept under review and, in order to give substance to the financial incentives, adequate quantities of consumer goods will continue to be made available to the agricultural sector. Negotiated procurement prices were recently introduced for coffee, and their application to other major crops such as cotton, tobacco, and maize is currently being considered.

To a large extent, further gains in rice output will have to come from an extension of the area under irrigation (currently 50,000 ha. or 7 per cent of the total rice area) and the provision of adequate agricultural implements. With the shortage of trained personnel and the absence of an effective input delivery program, the Government will concentrate its efforts mainly on areas with good prospects for improving productivity. The improvement of mechanization on existing cooperatives, and the formation of new cooperatives with some mechanization in areas with shortages of labor and draught animals, will also be considered. However, the participation of the farmers in cooperatives will remain voluntary.

The projected gains in rice output under the Plan may exceed the additional domestic requirements resulting from the growth in population and a somewhat higher per capita consumption. In that case, the authorities intend to use any excess production for the accumulation of stocks. In view of the variability in annual output of individual rice crops of 15 per cent, a stock level of about three months' official distribution is considered adequate to permit a reduction in the fluctuations of the free market price for rice and in the dependence on imported foodgrains. The effectiveness of future rice operations will depend greatly on further improvements in the domestic transportation system and on the construction or improvement of adequate storage facilities. The Five-Year Plan currently lacks sufficiently detailed provisions for adequate storage facilities.

Although Laos' forest resources are substantial, recent estimates of the area covered by forests with high quality timber indicate that these resources are not as large as once thought. In addition, indiscriminate cutting in the past appears to have reduced the potential yield of the more accessible areas. Caution regarding the rate of cutting that would be permissible if depletion is to be avoided has therefore been an important element in the Government's policy toward the forestry sector, in addition to the need to earn foreign exchange. All timber exports are subject to a government monopoly and since the middle of 1981, exports of newly cut logs have been banned, in order to promote the domestic processing industry. However, in view of the limited domestic processing facilities, the ban has been implemented with flexibility so far. Under the Five-Year Plan the authorities have established eight timber corporations, of which three are currently operational. With foreign assistance, each corporation will be in charge of the exploitation and reafforestation of specific areas. Since June 1981, procurement prices for timber have been increased by 190 to 400 per cent. However, the new prices are barely covering costs, and further price increases are required in order to make timber cutting remunerative.

In industry, the authorities aim at increasing the capacity utilization of existing factories, by rehabilitation of equipment, if necessary, and by assuring sufficient supplies of domestic and imported raw materials. Installation of new capacity is considered only for viable projects that can process domestic agricultural or forestry output. Lack of adequate technical and managerial skill appears to be a major constraint on the establishment and further development of industries. The staff team indicated that a government statement of policy on the establishment of industries by the private sector and on possible joint ventures with foreign enterprises would probably reduce this constraint. With the exception of the cement factory, which will be constructed with aid from the Soviet Union, there are no plans for the establishment of new factories.

2. Energy policies

Laos is both an importer and an exporter of energy. It relies heavily on imports of petroleum products for its commercial energy consumption, and most of its production of hydroelectricity is exported to Thailand. Despite a more than threefold rise in electricity production in 1979, after the completion of the second phase of the Nam Ngum Hydroelectricity Plant, Laos remained a net importer of energy in terms of foreign exchange, as the export price of electricity remained unchanged while the cost of petroleum imports more than doubled in 1980 and continued to rise thereafter. In October 1981, the price of exported electricity was raised by 200 per cent under a new contract with Thailand that also provides for annual price increases of 9 per cent until 1986. As a result of this rise in the export price of electricity, Laos became a net exporter of energy in 1982, and with the 36 per cent expansion in generating capacity due in 1984 after the installation of an additional turbine at the Nam Ngum Hydroelectricity Plant, it is expected that Laos

will remain a net exporter of energy for most of the 1980s.^{1/} During 1981, domestic electricity prices were raised sixfold to a level somewhat below the long-run marginal costs of production. With the devaluation of the kip in January 1982, the official price of gasoline rationed to government agencies and civil servants was raised by more than 200 per cent and corresponding changes were also made in the prices of other petroleum products. The authorities indicated that they intend to keep the pricing of petroleum at par with those on the world market and that periodic changes would be made in the future depending on developments in the landed costs of petroleum products.

3. Domestic resource mobilization and financial policies

Budgetary developments in recent years have been characterized by a steady growth of revenue that was generally faster than the growth of expenditures. An important result of this development has been that external financing of the budget as a proportion of total expenditures was reduced from about 58 per cent in 1979 to about 49 per cent for the revised budget estimates for 1982. These revised estimates also indicate that domestic revenue will exceed current expenditure for the first time in 1982. The excess is estimated at about 4 per cent of GDP and compares with a shortfall of about 5 per cent in 1980.

Part of the rise in government receipts, i.e., K 130 million in 1981 and K 150 million in 1982, is temporary as it stems from a reduction in excess inventories of state enterprises. Once the stocks of these enterprises have returned to more normal levels, which is expected toward the end of the year, the reflow of working capital to the budget will cease.^{2/} The authorities are aware that this factor should be taken into account in the preparation of the 1983 budget. In order to raise more revenue, they are considering an increase in the rate used for the valuation of customs duties from K 10 to K 35 per U.S. dollar. Other budget measures currently considered are a further reduction in the number of civil servants and other employees in the public sector, and improvements in the operational efficiency of state enterprises through greater autonomy and stricter controls on cost. Since 1979 state enterprises have been required to avoid operational losses and to maintain a small financial reserve to cover temporary setbacks. The rules for profit determination were tightened in 1982 when managers were requested to determine the number of their employees on the basis of the amount of work, and to exclude the cost of excess labor from the calculation of total production cost. On an experimental basis, three companies have recently been granted permission to retain 40 per cent of their profits (versus 10 to

^{1/} Exports of electricity in 1982 are projected at US\$23 million, while imports of petroleum products from the convertible area in 1982 are estimated at US\$12 million and those from the nonconvertible area at about US\$5 million. Since 1979, the volume of petroleum imports from the convertible area has been declining while that from the nonconvertible area have been increasing.

^{2/} Working capital of state enterprises is financed for 50 per cent by the budget and for 50 per cent by the banking system.

20 per cent for other companies) and to negotiate contracts with both foreign and domestic companies on a commercial basis. Both measures are expected to improve operational performance and, if confirmed, the Government intends to extend this new system of management to other companies as well.

In February 1982, the number of subsidized consumer goods was reduced from eleven to four (rice, sugar, fabrics and detergent). The rice procurement prices have been steadily raised in recent years, but the distribution price of rice to civil servants and employees of state enterprises has remained unchanged since January 1980 and, despite substantial reductions in the number of persons eligible to receive rice from the Government at low prices, the cost of the resulting subsidy is estimated at about K 360 million in 1982, or about 2.6 per cent of GDP. The subsidy is not a direct charge on the budget but, instead, is financed by the State Trading Company (STC) from profits made on imports of consumer goods and exports of timber. The authorities indicated that they will consider making the rice subsidy an explicit item in the budget and permitting the STC to set the domestic procurement price for timber on a commercial basis, without any consideration for the need to finance rice subsidies. A gradual reduction of the cost of the rice subsidy is envisaged through further reductions in the size of the civil service, a tightening of eligibility rules, and price adjustments.

Although the Five-Year Plan calls for an increase in domestic revenue of 70 per cent in real terms, the authorities do not believe that this objective can be attained. For the remaining period of the Plan, they intend to keep adjusting official prices in line with cost developments, to improve the operational efficiency of state enterprises, and to make further efforts to prune unnecessary expenditures from both the Government's current and capital budget. Except for use of a seasonal credit facility with the Lao National Bank at the beginning of the year to cover a lag between expenditures and revenues, the authorities do not envisage any borrowing from the domestic banking system during the remainder of the Plan period. The Government has refrained from borrowing from the banking system since 1979 and, although this has occasionally led to temporary lack of funds in certain areas, notably with regard to the domestic financing of aid projects, the authorities believe that it has also led to a greater degree of financial discipline throughout the Government. The initiation of new projects without proper domestic or foreign financing has been drastically curtailed.

Monetary and credit policies are essentially passive and accommodate mainly the liquidity and credit requirements of state enterprises, as determined by price policies and the official production plan. Since 1979, credit policies have also aimed at meeting the legitimate needs of the private sector. From a low base, credit to this sector has increased rapidly but remained virtually stationary during the first six months of 1982. The authorities explained that the rapid expansion in earlier years had led to some repayment problems and that the banks were now applying stricter eligibility criteria for private sector credit, including the requirement that complete financial statements and working plans for the medium term be submitted along with the credit application.

The new criteria signify a somewhat more cautious attitude of the banks in the light of past experiences, they do not indicate a more restrictive policy toward the private sector. As private enterprises become accustomed to the new procedures, credit to the private sector is expected to be resumed during the remainder of 1982. The authorities also felt that credit to public enterprises was being used more efficiently than in the past because of stricter criteria on the eligibility for credit and greater emphasis on profitability and proper cash management. Credit to public enterprises remained more or less stable during the first six months of 1982, due largely to the effect of the reduction in excess inventories. Although credit to both public and private enterprises is expected to accelerate during the second half of 1982, the increase in total credit for the year as a whole is estimated to remain below 25 per cent.

Laos has traditionally followed a policy of low interest rates, because most credit is allocated administratively and the scope for mobilizing private savings is limited. The staff team noted that, with the increasing financial and management autonomy of public enterprises and the private sector linkages with Thailand, it was important that the level of interest rates should reflect the scarcity of capital in Laos and at least the level of interest rates abroad. The Lao authorities concurred and indicated that a recent study on the structure and level of interest rates would probably lead to a decision to raise interest rates during the course of 1983. In order to promote savings and provide improved credit facilities to rural areas, the banking system has opened 52 new branch offices since 1979.

4. External policies

After having incurred deficits in both 1980 and 1981, the balance of payments is expected to record a small surplus of US\$1.5 million in 1982 (Table 3). A large rise in import payments, i.e., to US\$121 million from US\$90 million in 1981, will be more than offset by the effect of the tripling in the price of electricity exported to Thailand, a rise in exports to the nonconvertible area, and an increase in foreign aid receipts. The sharp increase in imports reflects the return to a more normal level of trade with Thailand following the closure of the border in 1981 and an expansion in purchases of equipment, raw materials and petroleum from the nonconvertible area. Despite the likely overall balance of payments surplus, the external position has continued to weaken in 1982, with the deficit on the current account estimated to reach US\$94 million, or 24 per cent of GDP.

Exports of timber--Laos' second most important foreign exchange earner after electricity--continued to stagnate and are likely to remain far below potential for the third year in a row. The Lao authorities explained that the low level of timber prices abroad and uncertainties with regard to the permissible rate of cutting had depressed timber sales

Table 3. Laos: Balance of Payments, 1979-82

(In millions of U.S. dollars)

	1979	1980	1981	1982 Jan.- June	1982 Proje- ction
Trade balance	50.9	-78.8	-70.8	-51.6	-73.1
Convertible area	-0.9	-27.5	-22.2	-9.5	-6.0
Nonconvertible area	-4.1	-4.7	-8.4	-12.1	-17.1
Aid financed imports <u>1/</u>	-45.9	-45.6	-40.2	-30.0	-50.0
Exports	19.4	13.5	19.4	18.0	47.8
Convertible area	19.4	13.5	14.0	11.8	29.9
Nonconvertible area	5.4	6.2	17.9
Imports	-70.3	-92.3	-90.2	-69.6	-120.9
Convertible area	-20.3	-42.0	-36.2	-21.3	-35.9
Nonconvertible area	-4.1	-4.7	-13.8	-18.3	-35.0
Aid financed imports <u>1/</u>	-45.9	-45.6	-40.2	-30.0	-50.0
Services and private transfers (net)	-21.2	-24.2	-20.8	-8.3	-21.1
Technical assistance	-25.0	-27.9	-28.0	-15.0	-30.0
Interest <u>2/</u>	-2.1	-1.8	-2.0	-1.3	-2.1
Other (net)	5.9	5.5	9.3	8.0	11.0
Current account	72.1	-103.0	-91.6	-59.9	-94.2
Capital and official transfers	80.7	83.8	86.9	56.2	95.7
Loans and grants	75.0	78.2	86.6	57.1	97.1
Amortization <u>2/</u>	-1.9	-1.3	-2.4	-0.9	-1.4
Other	7.6	6.9	2.7	--	--
Overall balance <u>2/</u>	6.6	-11.0	-5.8	-0.2	1.5
Financing	-6.6	11.0	5.8	0.2	-1.5
Assets (increase -)	-4.6	12.0	0.5	0.2	-1.5
Liabilities (decrease -)	-2.0	-1.0	5.3	--	--

Source: Based on data provided by the Lao authorities.

1/ From both convertible and nonconvertible area.

2/ Convertible area.

during the first half of 1982, but that export contracts with Thailand negotiated during the summer would lead to a rebound of exports during the second half of 1982. In view of the considerable potential of timber exports and the need to reduce the level of the current account deficit of the balance of payments, the staff team observed that a nationwide timber survey should be completed as soon as possible in order to determine the permissible rate of timber extraction, and that balance of payments consideration should be taken into account in the determination of a national timber policy. As a sizable stock of cut timber has accumulated in recent years (10,000 cubic meters in the Vientiane area alone), an acceleration of exports would, in any case, be possible in the years ahead. The authorities indicated that they were in the process of reorganizing the entire timber sector and that, in addition to foreign assistance in forest exploitation, they were also considering technical assistance from abroad in the area of marketing and pricing. Although domestic timber prices have recently been raised to allow for higher wages, there still is a substantial margin between the export prices and the prices that are paid to domestic timber cutters. Further increases in the official procurement prices are therefore being considered as part of a more comprehensive timber policy. Procurement prices of other exportable commodities, i.e., coffee, tea, and cotton will be adjusted in order to maintain adequate production incentives.

Laos' external debt has been increasing rapidly since 1975 and amounted to US\$312 million at the end of 1981, equivalent to 42 per cent of GDP. Even though most of the total debt is in long maturities and at low interest rates, the progressive expiration of grace periods is leading to a rapidly increasing annual debt servicing burden. In convertible currencies, debt service payments will increase from US\$3.5 million in 1982, or 12 per cent of convertible export earnings, to US\$15.9 million in 1985 (Table 4). External debt to CMEA countries, which in part has arisen because of the conversion of deficit balances under bilateral clearing arrangements into long-term loans, amounted to the equivalent of US\$192 million at the end of 1981. The mission indicated that although the servicing of these loans is not yet an undue burden on the balance of payments, debt obligations to the CMEA countries could increase rapidly, if the practice of converting deficit balances under clearing arrangements into long-term loans is to continue at the current rate.

An increasing volume of Laos' total external trade is made through unofficial channels at a parallel market exchange rate that has recently reached K 105 per U.S. dollar. The authorities agreed that, in view of the unsustainable level of the official current account deficit, the uncertain aid prospects, and the rising debt service burden, there was an urgent need for higher growth of official exports, and that, together with remunerative domestic procurement prices, a more active exchange rate policy would be essential for the achievement of that objective. They also indicated that the large discreet adjustments, which have characterized exchange rate policy in the past, are to be avoided in the future.

Table 4. Laos: External Debt Service Projections, 1982-85

(In millions of U.S. dollars)

	1982	1983	1984	1985
Total debt service	3.45	6.68	14.15	18.28
Capital	1.40	4.62	12.21	16.82
Interest	2.05	2.06	1.94	1.46
Multilateral loans	1.60	2.02	9.59	12.83
Capital <u>1/</u>	0.41	0.90	8.57	12.26
Interest <u>2/</u>	1.19	1.12	1.02	0.57
Bilateral loans	1.85	4.66	4.56	5.45
Convertible area	1.85	1.92	2.57	3.04
Capital	(0.99)	(0.98)	(1.65)	(2.15)
Interest	(0.86)	(0.94)	(0.92)	(0.89)
Nonconvertible area	--	2.74	1.99	2.41
Capital	(--)	(2.74)	(1.99)	(2.41)
Interest	(--)	(--)	(--)	(--)

Source: Data provided by the Lao authorities.

1/ Including repurchase obligations to the Fund and repayment of Trust Fund loans.

2/ Including Fund charges.

An important feature of recent balance of payments developments has been the rapid expansion of trade with other socialist countries. If continued, this development may lead 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 service payments on external debt in convertible currencies. In light of this possibility, the authorities agreed that the development of convertible export earnings should receive special consideration.

The exchange and trade system remains highly restrictive and bilateral payments agreements are maintained with the U.S.S.R., Bulgaria, Czechoslovakia, the German Democratic Republic, and with two Fund members, Viet Nam and Hungary. With the adoption of the rate of K 35 per U.S. dollar for all official transactions last January, the multiple currency practices that previously arose because of exchange premiums for tourist receipts, transactions with foreign embassies, and inward private remittances have been removed.

IV. Staff Appraisal

Following two years of record economic growth, the performance of the economy continued to be favorable in 1981, despite a leveling off in rice production and shortages in industrial inputs caused by a prolonged closure of the border with Thailand. Real GDP continued to expand and Laos' major achievement in recent years, self-sufficiency in food, was further consolidated. Prospects for further growth of GDP in 1982 have been limited by a drought that affected the summer rice crop, but a resumption of large-scale food imports is not anticipated.

In addition to favorable weather, the rapid expansion in agricultural output during the last four years has been due to the success of the authorities in reclaiming abandoned land and the application of production-oriented policies, including flexible pricing and the removal of restrictions on internal trade. Official procurement and retail prices were raised in 1980 and, after the re-emergence of significant distortions, again in early 1982. Despite the favorable production response from these measures and the progressive reduction in the rate of monetary expansion, pressures on free market prices in the Vientiane area have continued, due to border closures, interruptions in the domestic supply of foodgrains, and the effects of the depreciation of the kip in the parallel market.

Budgetary performance has improved in recent years. In addition to the effect of the recent price measures, the improvement also stems from better tax collection procedures and expenditure restraint. As a result of these developments, domestic revenue is expected to exceed current expenditure for the first time in 1982. Nevertheless, nearly half of total budget outlays remains foreign financed and additional revenue and expenditure measures, such as the intended raising of the customs valuation rate, and further reductions in the public sector labor force, are therefore appropriate. Considering the relative importance of the subsidy on official rice distribution, a further tightening of eligibility criteria and an increase in the distribution price may contribute importantly to higher public savings and a further reduction in the dependence on foreign financing of the budget.

Although the quantitative objectives of the Five-Year Plan appear ambitious in relation to the country's medium-term potential, the authorities have adopted a pragmatic approach toward its implementation and have refrained from initiating projects or programs for which no sufficient funds or competent technical and managerial skills are available. The main objective of the Plan, i.e., improvement of the transportation and communication system, will lead to a more even distribution of food and other consumer goods in the economy. In conjunction with the accumulation of a rice stock in the years ahead, this should contribute to a reduction of inflationary pressures in the free market.

Despite the absence of foodgrain imports and the rapid rise in electricity exports, the balance of payments remains weak. The current account deficit is now about one quarter of GDP. Debt service obligations in convertible currencies are expected to rise rapidly and, under bilateral arrangements, exports are increasingly directed toward the nonconvertible area. In view of these trends, an active exchange rate policy is necessary to promote exports, in particular those to the convertible area. The early adoption of a national timber policy that gives due consideration to adjustments in domestic timber prices and an improvement in timber marketing abroad would also be an essential element in the development of export earnings. The staff welcomes the elimination of the multiple currency practices that arose from exchange rate premiums on tourist receipts, transactions with foreign embassies, and inward private remittances.

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 1982 Article XIV consultation with the Lao People's Democratic Republic in the light of the 1982 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 welcomes the removal of the multiple currency practice arising from the maintenance of the preferential exchange rate as described in SM/82/ , and encourages the Lao People's Democratic Republic to terminate the bilateral payments arrangements with Fund members as soon as possible and to further liberalize its restrictive exchange system.

Fund Relations with Laos
(As of October 31, 1982)

Membership: 1961.

Status: Article XIV.

Quota: SDR 24 million.

Fund holdings of kip: 153.9 per cent of quota, of which
53.9 per cent on account of regular
facilities.

SDR position: SDR holdings amounted to SDR 0.04 mil-
lion or 0.4 per cent of total cumulative
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: US\$1.23 million.

Gold distribution: 11,533 fine ounces.

Exchange rates: The official exchange rate is K 10 per
US\$1. Since January 1982, a rate of
K 35 per US\$1 applies to all exchange
transactions; the rate of K 10 per
US\$1 is applied for customs valuation
purposes only.

Representative rate: K 10 per US\$1.

Article IV consultation: The last Article IV consultation was
held in July/August 1981 (SM/81/185
and SM/81/187), the Executive Board
discussed the Staff Report on October 7,
1981.

World Bank Group Operations in Laos

Summary

<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 rehabilitation and development	8.2
2. Approved	June 1979	IDA	Agricultural rehabilitation and development	10.4
3. Approved	April 1980	IDA	Agricultural rehabilitation and development	13.4
4. Approved	December 1981	IDA	Extension of Nam Ngum Dam	15.0

Description of assistance

The above credits were for agricultural rehabilitation and development, as well as the exploitation of Laos' hydroelectric resources. The Bank Group and the Government are presently discussing the types of assistance the LPDR will need in the future. Among the projects being discussed are: (1) support for high-priority inputs to facilitate the agricultural development program; (2) rural electrification in the southern provinces; and (3) industrial rehabilitation, focusing particularly on timber-processing for exports. The Bank Group also intends to send an export crops mission to the LPDR in 1983 to evaluate the export potential of agricultural products, in particular cotton and coffee.

The above projects would aim at providing inputs to improve the implementation of on-going agricultural development projects, at encouraging the Government's emphasis on developing infrastructure outside the Vientiane area, and at supporting export of forestry and other products. Until agreement has been reached with the Government on the scale and nature of the assistance to be provided, it is not possible to estimate the foreign currency costs of the presently proposed projects.

LAOS

Basic Data

<u>Population (1981)</u>	3.3 million			
<u>Population growth rate</u>	2.0 per cent per annum			
	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u> <u>Proj.</u>
<u>Output</u>				
Economic growth (per cent change)	10	10	5	1
GNP value (in billions of kip)	2.5	5.2	7.4	13.8
Rice ('000 tons)	520	625	666	636
Timber ('000 cu. m.)	131	140	147	150
<u>Prices</u>				
COL in Vientiane				
(change in per cent)	3	100	55	100
GDP deflator (change in per cent)	8	90	35	85
Parallel market exchange rate; kip per U.S. dollar (average for the year)	15	21	38	70-80
<u>Monetary survey (per cent change)</u>				
Credit to the public sector	45	150	24	-- 1/
Credit to the private sector	33	700	63	2 1/
Domestic liquidity	18	164	4	17 1/
<u>Budget (per cent change from previous year)</u>				
Current revenue	154	179	32	178
Current expenditure	3	161	--	120
Capital expenditure	28	209	24	247
<u>Official exports (US\$ mn.)</u>	<u>19.4</u>	<u>13.5</u>	<u>19.4</u>	<u>47.8</u>
To the convertible area	19.4	13.5	14.0	29.9
To the nonconvertible area	--	--	5.4	17.9
<u>Official imports (US\$ mn.)</u>	<u>70.3</u>	<u>92.3</u>	<u>90.2</u>	<u>120.9</u>
From the convertible area	20.3	42.0	36.2	35.9
From the nonconvertible area	4.1	4.7	13.8	35.0
Aid-financed imports	45.9	45.6	40.2	50.0
<u>Commodity composition of official exports to the convertible area (US\$ mn.)</u>				
Hydroelectric power	6.1	5.3	7.9	22.5
Timber	8.5	6.1	5.1	5.9
Coffee	4.1	1.1	--	1.2
Tin	0.2	0.5	0.4	--
Other goods	0.5	0.5	0.6	0.3

LAOS

Basic Data (concluded)

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u> <u>Proj.</u>
<u>Commodity composition of official imports</u>				
<u>from the convertible area (US\$ mn.)</u>	<u>20.3</u>	<u>42.0</u>	<u>36.2</u>	<u>35.9</u>
Foodgrains and other foodstuffs	1.3	10.7	2.0	1.6
Petroleum products	8.8	12.9	12.9	12.0
Equipment and raw materials	1.8	11.1))
Other goods	8.4	7.3) 21.3) 22.3
<u>External reserves (US\$ mn.)</u>				
Gross (end of period)	26.1	14.0	13.5	12.4
In months of imports	4.5	1.8	1.8	1.2
Net (end of period)	14.2	3.1	-1.5	-1.6
<u>External debt (US\$ mn.)</u>				
Outstanding (end of period)	215	266	312	395
To international institutions	29	39	47	56
To bilateral donors	183	224	262	336
Socialist countries	(...)	(153)	(192)	(265)
Non-socialist countries	(...)	(71)	(71)	(71)
Suppliers' credits	3	3	3	3
Servicing	3.3	2.5	3.8	2.5
As a per cent of exports of goods and services	15	15	13	5
<u>Selected ratios, expressed as a per cent of GDP</u>				
Total budgetary expenditure	25.4	34.2	26.4	39.7
Current revenue minus current expenditure	-5.0	-5.4	-0.5	3.6
Total budgetary deficit	14.7	19.8	13.1	19.7
Official exports of goods ^{2/}	3.1	2.6	2.6	12.1 ^{3/}
Official imports of goods ^{2/}	11.2	17.8	12.2	30.7 ^{3/}
Current account deficit ^{2/}	11.5	19.8	12.4	23.9 ^{3/}
External debt ^{2/}	34.4	51.2	42.2	100.2 ^{3/}
External debt servicing	0.6	0.6	0.5	0.9

1/ For January 1-June 30 period.

2/ Computed by converting nominal GDP into U.S. dollars at the official rate of exchange.

3/ Changes from 1981 are in part due to a sharp decline in the U.S. dollar value of GNP.