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March 30, 1992

To: Members of the Executive Board

From: The Secretary

Subject: Lao People's Democratic Republic - Staff Report for the  
1992 Article IV Consultation and Request for the Third Annual  
Arrangement Under the Structural Adjustment Facility

Attached for consideration by the Executive Directors is the staff report for the 1992 Article IV consultation with the Lao People's Democratic Republic and its request for the third annual arrangement under the structural adjustment facility. A draft decision appears on page 22.

This subject, together with the policy framework paper for the Lao People's Democratic Republic (EBD/92/47, 3/11/92), is tentatively scheduled for discussion on Monday, May 4, 1992.

Mr. Goldsbrough (ext. 4735) or Mr. Gunjal (ext. 7888) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)



INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

Staff Report for the 1992 Article IV Consultation and Request for  
Third Annual Arrangement Under the Structural Adjustment Facility

(In consultation with the Exchange and Trade Relations,  
Fiscal, Legal, and Treasurer's Departments)

Approved by Yusuke Horiguchi and S. Kanesa-Thanan

March 25, 1992

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## I. Introduction

The 1992 Article IV consultation discussions with the Lao People's Democratic Republic, together with the negotiations on a program to be supported by the third annual arrangement under the structural adjustment facility (SAF), were held in Vientiane during the period January 19-February 2, 1992. <sup>1/</sup>

In a letter dated February 29, 1992, which is accompanied by a Memorandum of Economic and Financial Policies for 1992, the Government requests a third-year SAF arrangement (Attachments I and II). Two loans totalling SDR 14.65 million (50 percent of quota) have already been disbursed under SAF arrangements, and a third loan of SDR 5.86 (20 percent of quota) will become available upon the Executive Board approval of the present request. After this loan is disbursed, outstanding Fund credit would amount to 70 percent of quota (Table 1).

The medium-term economic objectives and policies of the Government are described in the updated Policy Framework Paper (PFP) for 1992-94 prepared in collaboration with the staffs of the Fund and the World Bank (EBD/92/47, 3/11/92). It is expected that the PFP would be considered by the World Bank Executive Directors, at a meeting of the Committee of the Whole, on April 21, 1992. The authorities' adjustment and reform efforts are also being supported by policy-based lending from the World Bank and the Asian Development Bank (AsDB).

In concluding the last consultation, Executive Directors commended the authorities on the transformation from a centrally-planned to a market-oriented economic system, but expressed concern over the slow progress in securing macroeconomic stability. Directors stressed the need for consolidating public sector finances and tightening monetary policies in order to bring down inflation. They supported the authorities' emphasis on pursuing sound financial policies to protect the external competitiveness of the economy. They also recommended a strengthening of policy-making and implementation capabilities as crucial to sustaining the adjustment and reform efforts.

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<sup>1/</sup> The Lao representatives included Mr. Khamphoui Keoboualapha, Deputy Prime Minister and the Minister of Economy, Plan, and Finance (MEPF), Mr. Sisavath Sisane and Mr. Bousbong Souvanvavong, First Vice Ministers of MEPF, and Mr. Leuane Sombounkhan, Deputy Governor of the Bank of Lao P.D.R. The staff representatives were Mr. Goldsbrough (Head-CTA), Messrs. Merris (STA), Gunjal and Bell (both CTA), and Ms. Rosario (Administrative Assistant-CTA). Mr. Pham, the Resident Representative, assisted the mission, and Messrs. Funck and Sundberg of the World Bank participated in the discussions on the PFP. Mr. Ismael, the Executive Director, also attended the policy meetings.

Table 1. Lao P.D.R.: Fund Position, 1992-94

	Outstanding December 31, 1991	1992				1993				1994			
		QI	QII	QIII	QIV	QI	QII	QIII	QIV	QI	QII	QIII	QIV
(In millions of SDRs)													
Transactions under tranche policies (net)	--	--	--	--	--	--	--	--	--	--	--	--	--
Transactions under special facilities (net)	--	--	--	--	--	--	--	--	--	--	--	--	--
Structural adjustment facility loans	--	--	5.86	--	--	--	--	--	--	--	--	--	--
Total Fund credit outstanding (end of period)	<u>14.65</u>	<u>14.65</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>
Under tranche policies	--	--	--	--	--	--	--	--	--	--	--	--	--
Under special facilities	--	--	--	--	--	--	--	--	--	--	--	--	--
Under structural adjustment facility	<u>14.65</u>	<u>14.65</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>	<u>20.51</u>
(In percent of quota)													
Total Fund credit outstanding (end of period)	<u>50.0</u>	<u>50.0</u>	<u>70.0</u>	<u>70.0</u>	<u>70.0</u>	<u>70.0</u>	<u>70.0</u>	<u>70.0</u>	<u>70.0</u>	<u>70.0</u>	<u>70.0</u>	<u>70.0</u>	<u>70.0</u>
Under tranche policies	--	--	--	--	--	--	--	--	--	--	--	--	--
Under special facilities	--	--	--	--	--	--	--	--	--	--	--	--	--
Under structural adjustment facility	50.0	50.0	70.0	70.0	70.0	70.0	70.0	70.0	70.0	70.0	70.0	70.0	70.0

Source: IMF, Treasurer's Department.

Lao P.D.R. continues to avail itself of the transitional arrangements under Article XIV, Section 2. It has consented to an increase in quota and accepted the proposed Third Amendment of the Articles of Agreement.

## II. Background and Performance Under the SAF-Supported Programs in 1989-91

The systemic transformation of the Lao economy that began in 1985 achieved major progress in moving from a centrally-planned toward a market-oriented system, but also unleashed excess demand pressures. The dismantling of the previous system of transferring enterprise surpluses to the budget caused a drop in revenues and an increase in government dissavings, while the decentralization of enterprise decision-making was followed by large wage increases financed by bank credit. Accentuated by the effects of a prolonged drought in this predominantly agricultural economy, the result was a surge in inflation--which peaked at an annual rate of over 100 percent in mid-1989--a large external current account deficit, and a depletion of foreign reserves.

Thus, the challenge faced by the Government when it initiated a medium-term adjustment program in mid-1989 was to control inflation and achieve a more comfortable external position while persevering with the market-oriented reforms. The authorities' macroeconomic strategy focussed on tight monetary policies and a strengthened revenue performance to curtail government dissavings. Assisted by the end of the drought, they achieved considerable success. Economic growth recovered and inflation fell dramatically--to about 10 percent by end-1991 (Table 2 and Chart 1). Despite a weather related setback to rice production in 1991, real GDP rose by an estimated 4 percent as a result of strong growth in the small manufacturing and construction sectors, which benefitted from a growing inflow of foreign funds and technology.

The authorities' efforts to tighten monetary policy took place in the context of an ongoing restructuring of the financial system and at a time when indirect instruments of monetary control were still being developed. In these circumstances, the authorities relied upon two key policy instruments: sharp increases in interest rates to positive real levels (Chart 2), and instructions to bank managers to limit tightly new credit to public enterprises. Coupled with only moderate new bank credit to Government, the results were striking: domestic liquidity growth slowed from almost 90 percent in 1989 to about 10 percent in 1991 while declining inflation and exchange rate stability contributed to increased confidence in kip-denominated financial assets (Table 3).

The reduction in government dissavings (by over 1 percentage point of GDP) in 1991 was achieved by raising revenues as a share of GDP while containing and reorienting current expenditures. Two earlier rounds of tax reform were supplemented by a streamlining of turnover taxation and the

Table 2. Lao P.D.R.: Summary of Key Economic Indicators, 1988-94

	1988	1989	1990	1991		1992	1993	1994
				Prog.	Est.		Projections	
(Percentage changes)								
Real GDP growth	-1.8	13.5	6.6	5.0	4.0	6.5	5.1	5.2
Of which:								
Agriculture	-4.2	10.7	8.6	4.9	-2.5	6.0	...	...
Industry	-2.4	34.3	15.7	5.5	29.8	8.8	...	...
Services	4.1	11.3	-2.6	5.4	2.8	5.5	...	...
Consumer prices (end of period)	14.8	75.9	19.6	14.0	10.4	6 - 7	5.0	5.0
Liquidity 1/	37.0	89.3	14.0	7.1	9.7	13.0	12.0	11.5
Growth in credit to nongovernmental sector	53.6	73.0	11.6	32.5	4.8	25.9	18.0	13.0
Interest rate on one-year deposit (in percent; end-period)	14.0	36.0	36.0	...	18.0	...	...	...
Exports (value) 2/	-17.2	6.3	18.5	7.3	1.3	11.1	14.7	17.9
Imports (value) 2/	-29.5	11.2	15.1	23.7	7.2	22.6	7.7	6.2
(In percent of GDP)								
Government revenue	12.5	8.2	9.9	10.2	10.9	11.8	12.5	13.5
Government expenditure	32.9	24.7	23.4	21.9	20.4	20.7	21.8	23.0
Current	12.3	9.3	11.4	10.9	11.3	11.2	11.0	11.0
Capital	20.6	15.4	12.0	11.0	9.1	9.5	10.8	12.0
Government current account balance 3/	0.2	-1.1	-1.5	-0.7	-0.4	0.6	1.5	2.5
Overall balance (cash)								
With grants	-14.8	-12.5	-10.7	-9.2	-5.7	-4.9	-5.5	-5.3
Without grants	-20.3	-16.4	-14.4	-12.1	-10.2	-9.4	-9.3	-9.5
Domestic financing	0.1	-3.4	0.8	0.9	1.6	-0.5	--	--
Foreign financing	14.7	15.9	9.9	8.4	4.1	5.4	5.5	5.3
External current account								
With grants	-9.5	-6.3	-7.6	-10.6	-6.3	-8.2	-7.8	-6.5
Without grants	-19.5	-14.8	-14.3	-16.2	-12.9	-14.8	-14.2	-12.9
Debt service ratio 4/	20.0	17.4	15.2	14.6	15.7	15.0	13.9	12.5
Gross official reserves								
In millions of U.S. dollars	16.7	42.0	61.1	60.0	55.1	66.0	72.0	78.0
In weeks of total imports	5.7	12.9	16.2	13.6	13.7	13.4	13.5	13.8

Source: Data provided by the Lao authorities.

1/ Broad money supply, including foreign currency deposits.

2/ In terms of U.S. dollars.

3/ Excludes grants.

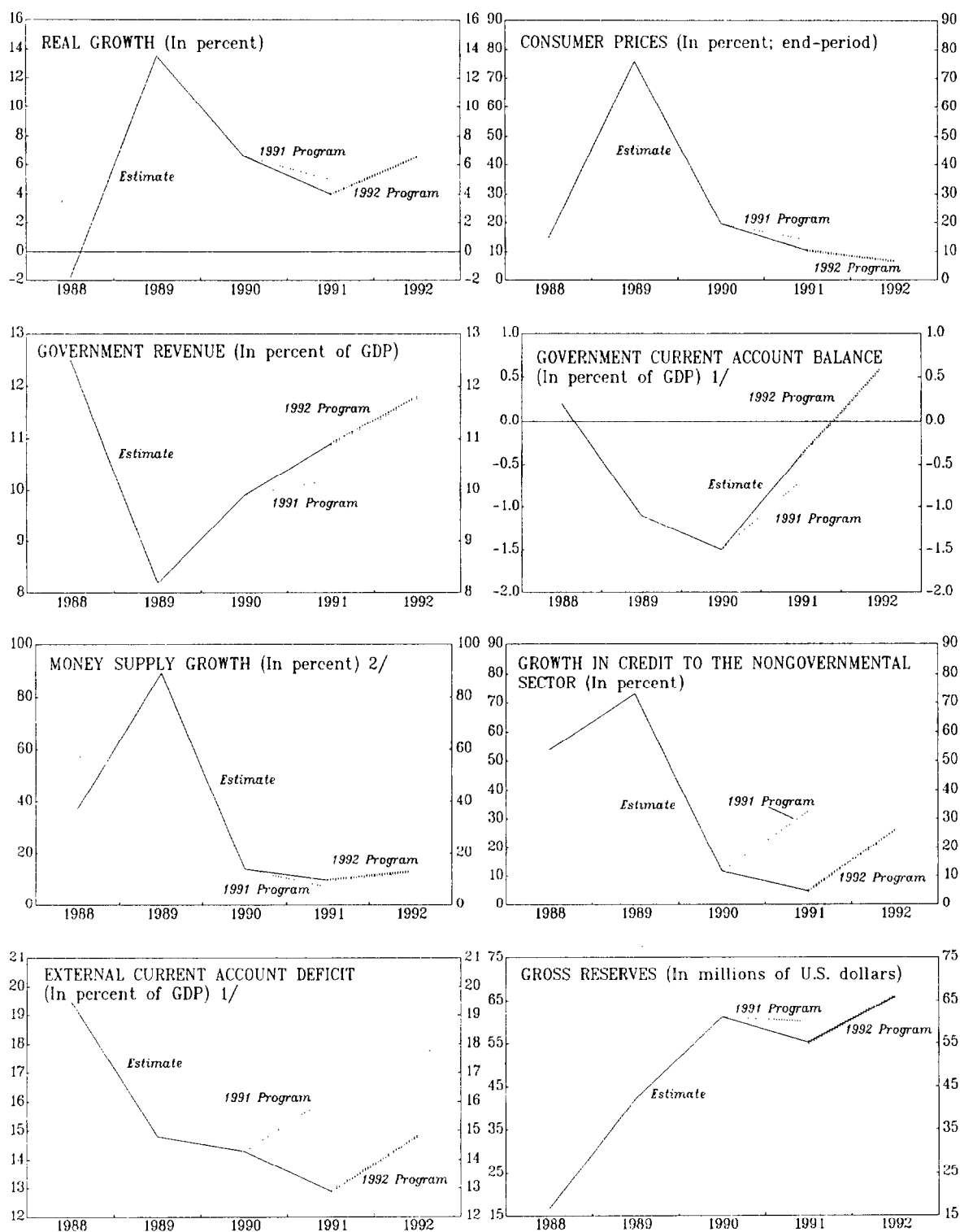
4/ As a ratio of exports of goods and services.



CHART 1

LAO P.D.R.

# SELECTED KEY INDICATORS, 1988-92



Source: Data provided by the Lao authorities.

1/ Excluding grants.

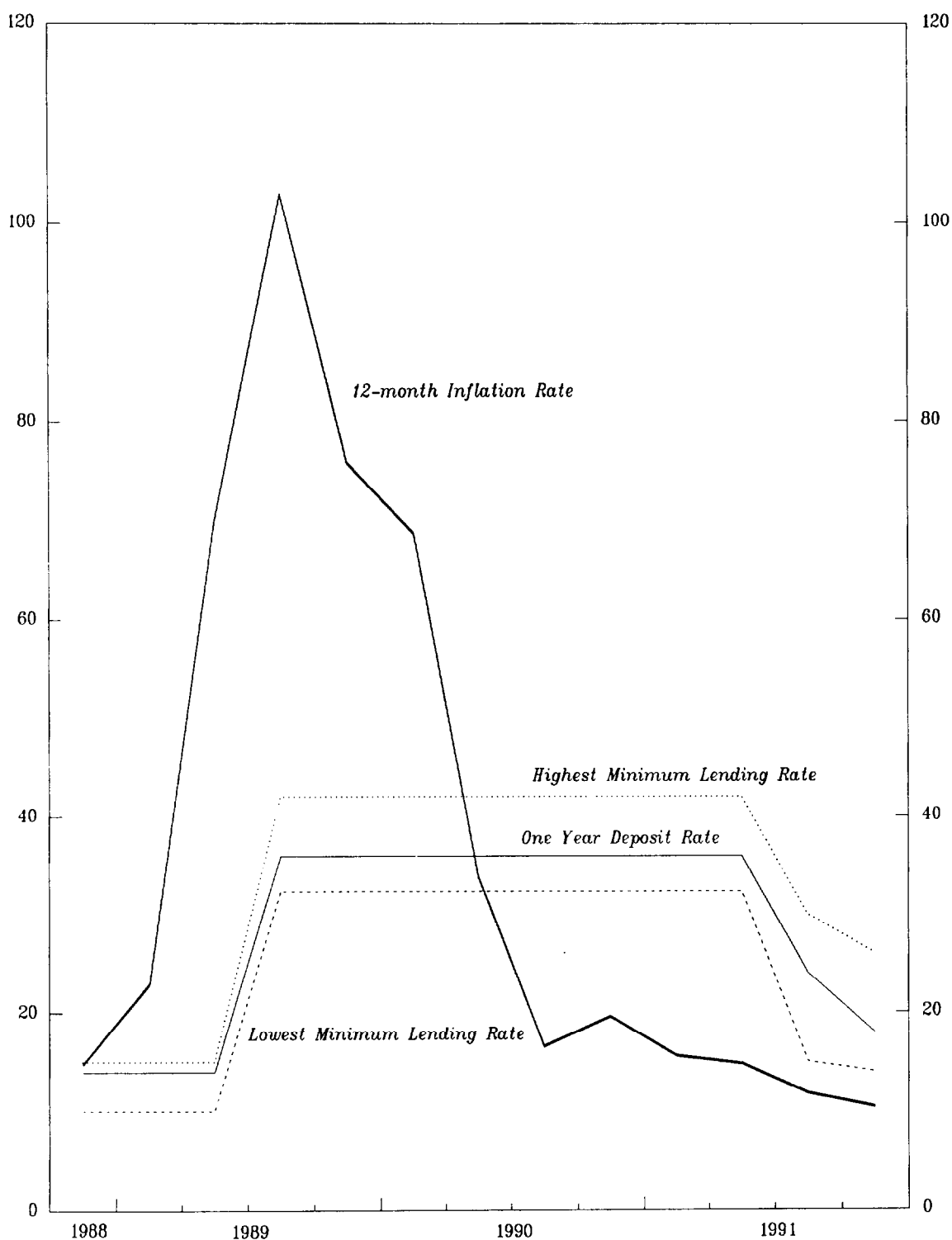
2/ Broad money supply, including foreign currency deposits.



CHART 2

LAO P.D.R.

# MINIMUM INTEREST RATES 1/ AND INFLATION, 1988-91



Source: Data provided by the Lao authorities.

1/ Minimum lending rates vary for different sectors; the lowest minimum rate applies to loans to agriculture and the highest minimum rate applies to loans to trade and services; minimum lending rates for other sectors, such as industry and construction, fall in between these two rates.



Table 3. Lao P.D.R.: Monetary Survey, 1988-92 <sup>1/</sup>

	December					
	1988	1989	1990	1991		1992
				Prog.	Est.	Prog.
(In billions of kip: end of period)						
Net foreign assets <sup>2/</sup>	1.5	20.5	28.3	15.2	15.5	17.1
Net domestic assets	<u>20.2</u>	<u>20.6</u>	<u>18.5</u>	<u>29.8</u>	<u>35.9</u>	<u>41.0</u>
Domestic credit	26.5	26.3	31.2	43.1	43.9	50.5
Net credit to Government <sup>2/</sup>	2.8	-14.8	-14.6	-12.5	-4.1	-10.0
Credit to nongovernment sector	23.7	41.0	45.8	55.6	48.0	60.5
Public enterprises <sup>3/</sup>	22.9	36.6	39.6	46.1	32.5	32.5
Private sector <sup>3/</sup>	0.9	4.4	6.2	9.6	15.6	28.0
Other items (net)	-6.3	-5.6	-12.6	-13.3	-8.0	-9.5
Liquidity	<u>21.7</u>	<u>41.1</u>	<u>46.9</u>	<u>45.0</u>	<u>51.4</u>	<u>58.1</u>
Narrow money	12.1	25.1	27.5	29.8	31.3	34.2
Quasi-money	9.6	16.0	19.3	15.2	20.1	23.9
(Annual percentage changes)						
Net credit to nongovernment sector	53.6	73.0	11.6	20.2	4.8	25.9
Liquidity	37.0	89.3	14.0	7.1	9.7	13.0
Memorandum item:						
Velocity of money	12.2	13.7	13.9	16.7	14.8	15.1

Sources: Data provided by the Lao authorities; and staff projections.

<sup>1/</sup> Excludes assets and liabilities of the Joint Development Bank, a commercial bank established in October 1989.

<sup>2/</sup> Excludes IMF Trust Fund loans which are included as foreign financing of the budget. Includes liabilities from borrowing under the Structural Adjustment Facility.

<sup>3/</sup> Reflects the reclassification of credit in the monetary survey from public enterprises to the private sector following privatization.

introduction of new excise taxes (mainly on petroleum products, alcohol, and cigarettes). 1/ At the same time, a major effort to strengthen tax collection was initiated through the establishment of national tax administrations to replace the previous provincial systems. Although several minor taxes expected under the 1991 program were not introduced, revenues responded buoyantly, rising to almost 11 percent of GDP compared with a little over 8 percent in 1989 (Table 4). Delays in the start of several large foreign-financed infrastructure projects, together with continuing shortages of domestic counterpart funds, caused a significant decline in capital spending in 1991 so that the overall budget deficit fell by almost one half to under 6 percent of GDP. Temporary delays in disbursements of several foreign program loans caused net credit to Government to exceed the end-year program benchmark, with a corresponding shortfall in external reserves (Table 5). However, the situation was largely restored in early 1992 when the program loans were disbursed.

The external position strengthened considerably during 1989-90. The current account deficit declined in response to tighter domestic financial policies and an improved supply position, while stepped-up aid inflows from multilateral and bilateral donors more than offset the sudden loss of financial assistance from the Soviet Union. In 1991, trade with the former Soviet Union--which had previously accounted for about one-fifth of total trade--collapsed, but buoyant export sales (especially of electricity and logs) to the convertible area and higher private transfers attracted by a renewed confidence in the Government's policies helped the economy to weather the shock. With import growth restrained primarily by the under-implementation of capital expenditures, the current account deficit (excluding official transfers) fell to 13 percent of GDP in 1991, compared with almost 15 percent in 1989. The overall balance shifted into deficit in 1991 as a result of the temporary delays in program loan disbursements, but reserves rebounded in early 1992. 2/

During 1990-91, the authorities pursued a policy of adjusting the official exchange rate to reflect changes in the parallel market rate. The spread between the two rates only occasionally exceeded 2 percent. The high interest rate policy and substantial inflows of official financing and private transfers kept the two rates generally stable. With domestic inflation remaining above international levels, the measured real effective exchange rate appreciated by about 15 percent during 1990-91, although a

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1/ The earlier rounds of tax reform, in March 1988 and July 1989, are described in the Recent Economic Developments report for the 1990 Article IV consultation (SM/90/217, 11/14/90).

2/ At end-February 1992, total gross reserves amounted to \$85 million.

Table 4. General Government Budget, 1988-92

	1988	1989	1990	1991		1992
				Prog.	Est.	Prog.
(In billions of kip)						
Revenue	<u>28.5</u>	<u>35.5</u>	<u>60.9</u>	<u>74.2</u>	<u>79.0</u>	<u>98.4</u>
Tax	21.5	27.4	37.6	53.3	54.4	69.7
Nontax	7.0	8.1	23.3	20.9	24.6	28.8
Of which: Sale/lease of public enterprise assets	(--)	(--)	(6.3)	(4.6)	(8.0)	(11.8)
Grants	<u>12.6</u>	<u>16.9</u>	<u>23.0</u>	<u>20.9</u>	<u>32.6</u>	<u>37.7</u>
Expenditure	<u>75.0</u>	<u>106.4</u>	<u>143.4</u>	<u>159.1</u>	<u>147.8</u>	<u>172.8</u>
Current expenditure <u>1/</u>	28.0	39.9	69.8	79.4	82.0	93.4
Wages and salaries	(11.2)	(19.6)	(35.6)	(38.6)	(36.7)	(41.2)
Materials and supplies	(15.5)	(15.3)	(26.1)	(28.3)	(32.8)	(35.9)
Transfers	(0.2)	(2.5)	(4.8)	(6.1)	(7.7)	(10.6)
Interest payments	(1.0)	(2.5)	(3.3)	(6.4)	(4.7)	(5.7)
Capital expenditure <u>2/</u>	47.0	66.5	73.6	79.7	65.8	79.4
Overall balance (commitment basis)	<u>-33.9</u>	<u>-54.0</u>	<u>-59.5</u>	<u>-63.9</u>	<u>-36.3</u>	<u>-36.7</u>
Clearance of arrears (net) <u>3/</u>	--	--	5.9	3.2	5.0	4.0
Overall balance (cash basis)	<u>-33.9</u>	<u>-54.0</u>	<u>-65.4</u>	<u>-67.1</u>	<u>-41.3</u>	<u>-40.7</u>
Total financing	<u>33.9</u>	<u>54.0</u>	<u>65.4</u>	<u>67.1</u>	<u>41.3</u>	<u>40.7</u>
Domestic financing (net)	0.2	-14.5	5.1	6.2	11.7	-4.0
Bank	(0.2)	(-14.5)	(0.1)	(1.2)	(10.5)	(-5.8)
Nonbank	(--)	(--)	(5.0)	(5.0)	(1.2)	(1.8)
Foreign financing (net) <u>2/</u>	33.6	68.5	60.3	60.9	29.6	44.7
(In percent of GDP)						
Revenue	12.5	8.2	9.9	10.2	10.9	11.8
Expenditure	32.8	24.7	23.4	21.9	20.4	20.7
Current expenditure	12.3	9.3	11.4	10.9	11.3	11.2
Of which: Wages and salaries	(4.9)	(4.5)	(5.8)	(5.3)	(5.1)	(4.9)
Capital expenditure <u>2/</u>	20.6	15.4	12.0	11.0	9.1	9.5
Current balance <u>4/</u>	0.2	-1.0	-1.5	-0.7	-0.4	0.6
Overall balance (cash basis)	-14.8	-12.5	-10.7	-9.2	-5.7	-4.9

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

1/ Includes defense expenditure.

2/ The budget investment and financing figures are understated for the period 1988-90 to the extent that an overvalued exchange rate was used to value foreign assistance from the nonconvertible currency area. Data do not include foreign technical assistance financed by aid.

3/ Includes net change in normal end-year carryover.

4/ Excluding grants.

Table 5. Lao P.D.R.: Status of Quantitative and Policy Benchmarks  
for the Second Annual Arrangement of the Structural  
Adjustment Facility, 1991

(As of December 31, 1991)

	1991			
	March	June	Sept.	Dec.
(In billions of kip)				
I. <u>Quantitative benchmarks</u>				
Banking system				
1. Net domestic assets <u>1/</u> <u>2/</u> (Cumulative flow) <u>3/</u>				
Benchmark	2.8	5.2	7.2	8.3
Actual	-1.2	4.4	6.8	17.3
2. Net credit to Government (Cumulative flow) <u>3/</u>				
Benchmark	0.45	0.90	1.05	1.25
Actual	-6.77	-3.16	-0.04	10.50
(In millions of U.S. dollars)				
Gross international reserves (Stock at end of period) <u>2/</u>				
Benchmark	63.0	62.0	61.0	60.0
Actual	71.2	69.3	68.0	55.1
New nonconcessional external loans contracted or guaranteed by the public sector (cumulative on a 12-month basis)				
a. 1-12 years <u>4/</u>				
Benchmark	5.0	5.0	5.0	5.0
Actual	--	--	--	...
b. Less than 1 year <u>5/</u>				
Benchmark	--	--	--	--
Actual	--	--	--	...



Table 5. Lao P.D.R.: Status of Quantitative and Policy Benchmarks  
for the Second Annual Arrangement of the Structural  
Adjustment Facility, 1991 (concluded)

(As of December 31, 1991)

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II. Policy benchmarks

1. Foreign exchange market

Introduce a centralized system of official reserve management within the Bank of Lao P.D.R. by November 30, 1991.

Observed.

2. Monetary instruments

Open a formal credit window in the Bank of Lao P.D.R. by June 30, 1991.

The credit window was opened in January 1992.

3. Interest rates

Set the lending rate of the central bank at a positive level in real terms in comparison with projected inflation. Issue guidelines to the commercial banks indicating the minimum interest rate to be paid by commercial banks on one-year time deposits. 6/

Observed.

4. Exchange rate policy

Maintain the difference between the official and parallel market rates below 10 percent through December 1991.

Observed.

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1/ Net domestic assets of the banking system are defined as the difference between the stock of bank liquidity (M2) and net foreign assets excluding the valuation impact of exchange rate changes.

2/ The benchmarks on net domestic assets and gross international reserves will be adjusted in the event of a higher-than-projected world oil price in accordance with the contingent arrangement described in EBS/91/32.

3/ Cumulative flows measured from the actual stock outstanding at end-December 1990.

4/ Excluding the finalization of a loan contract for the purchase of two airplanes by Lao Aviation.

5/ Excluding normal import-related credits.

6/ Benchmark to be in effect throughout the year. The projected inflation rates will be reassessed on a quarterly basis.

significant part of this appreciation reflected increases in domestic administered prices of tradable goods (Chart 3). 1/ 2/

### III. Strategy for the Period 1992-94 3/

The authorities' medium-term goals are to achieve an average real GDP growth of at least 5 percent while reducing inflation to the levels prevailing in major international partners (and no more than 5 percent) and further consolidating the external position.

The strategy to achieve these goals will continue to rest on the twin pillars of macroeconomic stabilization and systemic reform. Despite considerable success during the last two years, the authorities expect the next phase of reducing inflation to prove especially difficult because of the sensitivity of prices to possible adverse supply shocks in agriculture and because a few important domestic wage and price relativities still require further adjustment (including domestic electricity prices and the extremely low civil service wages). Therefore, they intend to maintain tight financial policies in order to prevent a resurgence of demand pressures and inflationary expectations. Sustaining such policies over the medium term will require the development of strong, centralized macroeconomic institutions. The next stage of systemic reforms is designed to promote a further major expansion in the role of the private sector (both domestic and foreign) in economic activity by greatly accelerating the pace of enterprise privatization and by further strengthening the legal and regulatory framework. An important part of the strategy is to promote the increased integration of Lao P.D.R. into the regional and world economies through further trade liberalization and the encouragement of foreign investment.

The authorities' medium-term fiscal strategy remains broadly unchanged. Significant government savings (2.5 percent of GDP by 1994) are to be achieved by further improvements in revenue performance while current

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1/ For example, the average domestic price of electricity--Lao P.D.R.'s principal export--was raised by a cumulative 150 percent during 1990-91. By shifting the domestic price closer to the true cost of production and discouraging local consumption, this adjustment improved the external position, but caused an appreciation in the measured real effective exchange rate index.

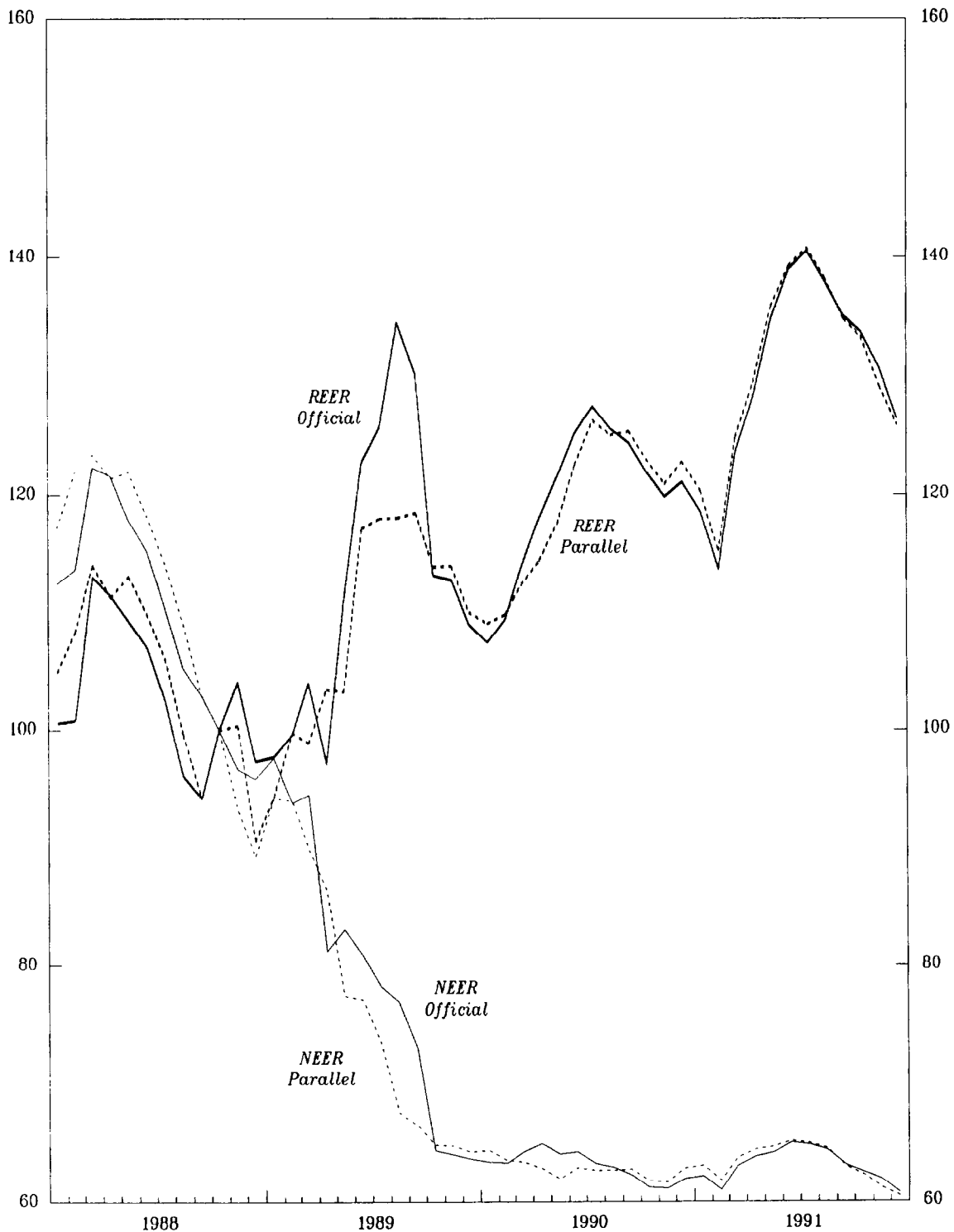
2/ A more detailed analysis of exchange rate developments is contained in the forthcoming background paper.

3/ A more detailed account of the authorities' medium-term objectives and policies is provided in the Policy Framework Paper, 1992-94 (EBD/92/47, 3/11/92).

CHART 3

LAO P.D.R.

NOMINAL AND REAL EFFECTIVE EXCHANGE RATES, 1988-91<sup>1/</sup>  
(October 1988=100)



Source: Data provided by the Lao authorities; and IMF, International Financial Statistics (IFS) and staff estimates.

1/ Based on a currency basket comprising the currencies of the five most important partner and competitor countries of Lao P.D.R.



expenditures remain about 11 percent of GDP (Table 2). 1/ Revenue mobilization will focus on the ongoing strengthening of tax collection, a review of timber royalties, sharp increases in user fees, and the introduction of several business taxes originally planned for 1991. 2/ A sustained increase in public investment (from an estimated 9 percent of GDP in 1991 to 12 percent of GDP by 1994) is planned, with four fifths of total spending allocated to economic and social infrastructure. The precise magnitude and phasing of the public investment program will be tailored to the availability of external financing. There will be no further bank financing of the budget, other than for temporary seasonal purposes.

Weaknesses in fiscal administration pose the most significant threat to maintaining financial discipline. Prior to 1991, the provincial governments had substantial powers to collect and spend revenues, but did not possess the necessary administrative capacity. The fragmentation of administration weakened both revenue collection and expenditure control. The Government has started a program of fiscal centralization that has already made significant progress on the revenue side. The next stage, now underway, involves the formulation of a single national budget and the establishment of a national Treasury administration with an effective accounting system. A comprehensive program of technical assistance is being prepared in support of these efforts. The staff emphasized that an early completion of these reforms was essential for sound fiscal management.

The authorities plan to cut the size of the over-manned civil service by about one quarter (net of new hires in priority areas) during 1992-93 and use the savings to raise civil service salaries. A similar retrenchment of defense personnel is planned, but the authorities could not yet provide details to the staff on the magnitude of the planned cut in defense personnel. The authorities expect the civil service reform to contribute to a greatly improved delivery of services, especially for health and education, since the present extremely low salaries have led to widespread absenteeism and low productivity. Severance payments will amount to about 1/2 percent of GDP in each of the two years.

In the authorities' view, tight monetary policies had not imposed an undue constraint on economic activity, largely because the credit squeeze had been concentrated on the public sector. In the period ahead, they expected that the bulk of new credit would continue to be channelled to the private sector. They regarded the use of minimum interest rate guidelines and informal limits on credit to public enterprises as effective policy tools during the current transitional period, but recognized that indirect

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1/ Medium-term targets expressed as a share of GDP are somewhat lower than those contained in the Board paper accompanying the request for a second annual arrangement under the SAF (EBS/91/32, 3/4/91) because of the upward revision of the GDP series.

2/ Further details on revenue and expenditure policies are contained in paragraphs 17 and 18 of the Policy Framework Paper.

instruments of monetary control would be more sustainable in the longer term since they were better suited to the needs of a market economy. The development of such instruments was already well underway, although their effective operation would depend upon a further strengthening of financial institutions. The medium-term goal was to allow commercial banks to determine their own interest rates to reflect market conditions, but, as an interim measure, the authorities intended to continue setting minimum rates, which would be kept above projected inflation. The staff agreed with this approach, but advised against using such guidelines to establish widely different lending rates for different economic activities, which would distort resource allocation. The existing differentials between minimum lending rates should be phased out at an early stage.

The state-owned commercial banks have inherited significant bad and doubtful debts incurred by public enterprises. <sup>1/</sup> An evaluation of the magnitude of these debts, with AsDB technical assistance, is now scheduled for completion in 1992. The authorities will then formulate proposals for bank recapitalization, including options for increased private equity participation. While welcoming these initiatives, the staff also stressed the importance of strengthened bank supervision, the paramount need for which was highlighted by the recent failure of several small, unregulated credit cooperatives.

The authorities indicated that they were satisfied with the existing exchange rate arrangements, which they intended to continue for a further transitional period. They saw the maintenance of a close link between the official and parallel market rates as conveying significant advantages, most notably by minimizing the diversion of transactions to the unofficial market. However, they regarded the option of allowing the spread between the two rates to widen up to 10 percent as an important safety valve should the parallel market rate be subject to temporary influences that did not reflect any underlying change in the external position. Except in such circumstances, the spread between the two rates would be kept within much narrower limits. Although precise estimates were not possible, the authorities indicated that the volume of transactions through the parallel market was probably substantially less than through the official market; however, they expected the unofficial market to remain significant in the period ahead, driven in part by the desire to avoid tax, trade, and capital controls.

In the authorities' view, the present exchange rate provided adequate incentives for the growth and diversification of exports. They intend to review the present arrangements after inflation has been reduced to no more than that prevailing in major trading partners, at which point they will consider pegging the kip to an appropriate currency basket. They noted that

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<sup>1/</sup> At present, 7 of the 8 commercial banks are wholly state-owned; the other bank is a joint venture with 70 percent foreign ownership.

the ongoing structural reforms, especially the proposed trade liberalization, might cause significant shifts in the underlying real equilibrium exchange rate. The staff agreed that, in these circumstances, a continuation of the present arrangements would be warranted during 1992, but saw considerable advantages in subsequently pegging the exchange rate to a basket of currencies, in order to consolidate confidence in the kip and provide a guidepost for the continuation of tight monetary policies.

The authorities have decided upon a major acceleration of the privatization program, but with more formal procedures for asset valuation and the assessment of proposals. Only five enterprises (of which the most important is the electricity company) are definitely reserved for the public sector. Proposals for the privatization of all other units will be considered on their merits, and all options (including sale, lease, and joint ventures) are open for consideration. The authorities expect significant participation by foreign investors. The initial goal is to privatize units accounting for 30 percent of the public enterprise labor force by end-1993. 1/

The authorities agreed with the staff on the importance of preventing a surge in wages and benefits prior to privatization. However, they have concluded that wage controls would not be an effective policy instrument and intend to continue relying primarily on tight credit restraint. While supporting the basic thrust of this approach, the staff cautioned that a recent decree providing for the establishment of a minimum wage might put upward pressure on the entire wage structure. In response, the authorities noted that implementing guidelines had not yet been issued and would be designed so that any wage increase that resulted was moderate.

The authorities' principal trade policy goal is to remove most quantitative trade restrictions by the end of 1992. Quantitative controls over a few items (including timber exports) will be retained, but such restrictions will be for environmental or security reasons. A further round of tariff reform in 1992-93 will reduce the present excessive number of exemptions and simplify tariff bands. The staff emphasized that any protective tariffs should be kept at a moderate level.

An initial assessment of the social impact of the adjustment and reform program suggests that the population engaged in the rural market economy has benefitted significantly from higher agricultural prices, the removal of internal trade barriers, and the reduction in the inflation tax. However, the poorest groups in society--namely, that half of the population engaged primarily in subsistence agriculture--has remained largely unaffected by the changes; the Government's policy for improving their welfare will focus on facilitating their integration into the market economy and on a more efficient delivery of basic social services. Those laid-off from the civil

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1/ Details of the proposed timetable, prepared with World Bank assistance, are contained in paragraph 24 of the Policy Framework Paper.

service and privatized enterprises are expected to suffer at least a temporary decline in living standards, partially mitigated by the provision of severance payments. Since many civil servants are already engaged in a second economic activity in order to earn an adequate income, the authorities do not anticipate a significant increase in open unemployment. Their strategy is to rely upon growing job opportunities in the expanding private sector to absorb any excess labor and to raise living standards.

#### IV. The Program for 1992 <sup>1/</sup>

The program for 1992 aims to (i) achieve real GDP growth of 6 1/2 percent, based on a recovery in agricultural production and the continued buoyancy of manufacturing and construction; (ii) reduce inflation to 6-7 percent by end-year; and (iii) limit the external current account deficit (excluding official transfers) to about 15 percent of GDP while maintaining total foreign reserves at over three months of imports.

Fiscal policies are designed to improve government savings by a further one percentage point of GDP, primarily through a strengthened revenue effort. This effort will include both new measures (a 5 percent minimum customs duty for all imports, increased company and inheritance taxes, and higher user fees) as well as the continued strengthening of tax enforcement. Receipts from privatization (conservatively estimated at 0.8 percent of GDP) will not be used to support a permanent build-up in expenditures, but will help finance severance payments and some special projects that will only be undertaken if revenues attain targeted levels. Current spending is to be held constant as a share of GDP and will incorporate the first stage of the planned civil service retrenchment. Capital spending is programmed to increase to 9.5 percent of GDP with the commencement of several large foreign-financed infrastructure projects, including the bridge over the Mekong and highway rehabilitation.

Taking into account the output and inflation targets, the financial program seeks to limit domestic liquidity growth to 13 percent, which would leave the velocity of money broadly unchanged. A partial reconstitution of government deposits is targeted, reflecting the disbursement of program loans delayed from the previous year. Credit to the nongovernmental sector will remain restricted, in order to leave room for a continued rapid growth in credit to the private sector.

The proposed policy and quantitative benchmarks are detailed in Tables 1 and 2, respectively, of Attachment II. In light of the central importance of the improved revenue effort to the success of the authorities'

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<sup>1/</sup> A more detailed account of objectives and policies is provided in the Memorandum of Economic and Financial Policies for 1992 (Attachment II).



strategy, a benchmark on cumulative tax revenues has been proposed, aggregating the targets for each major tax category established by the authorities as part of their tax enforcement effort. Preparation of an action plan for improving the statistical base by end-September 1992 has been proposed as a policy benchmark to emphasize the need to remedy widespread weaknesses in macroeconomic statistics that have hampered policy implementation. 1/

#### V. Balance of Payments Prospects and Capacity to Repay the Fund

Balance of payments projections for 1992 and the medium term have been prepared in the context of the authorities' medium-term fiscal strategy geared to stepping up public savings and investment and external policies designed to foster Lao P.D.R.'s increased integration into the world economy. Significant export growth (11 percent in nominal terms) is expected in 1992 as a result of a recently negotiated price increase for electricity exports to Thailand, the coming-on-stream of several foreign investment projects--especially in the garment sector--and increased opportunities for agricultural trade following Thailand's agreement to lower import tariffs on a range of products. However, total imports are projected to grow by about 22 percent, driven in part by the planned acceleration in public investment. The external current account deficit (excluding official transfers) is expected to widen to about 15 percent of GDP (Table 6). Aid disbursements, especially of concessional loans, are expected to increase substantially because of the pickup in foreign-financed projects and disbursements under World Bank and AsDB program loans. 2/ Several bilateral donors have also recently increased their aid commitments. Foreign investment inflows are also expected to continue growing as a result of both the acceleration in privatization of state enterprises and new investment opportunities created by the reforms. Total gross reserves are targeted to remain at about 3 1/2 months of imports. While this is a relatively comfortable level, the staff noted that it included the reserves of the

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1/ A start has already been made to improve macroeconomic statistics. National income accounts were recently revised with technical assistance from the World Bank. Major deficiencies persist in the fiscal accounts, however, owing primarily to the incomplete returns from the provinces and the poor quality of the capital expenditure accounts. Also, there continue to be significant classification problems in the monetary accounts, and the operations of the joint venture commercial bank have not yet been incorporated into the monetary survey. A multitopic STA mission is scheduled to visit the Lao P.D.R. in May/June 1992 to address these problems. More generally, Sweden is providing technical assistance aimed at the strengthening of the State Statistical Center, including the development of selected sectoral statistics.

2/ Disbursements under World Bank and AsDB program loans are projected at \$47 million in 1992, of which \$16 million was already disbursed in January-February.

Table 6. Lao P.D.R.: Balance of Payments, 1988-98 <sup>1/</sup>

(In millions of U.S. dollars)

	1988	1989	1990	1991		1992	1993	1994	1995	1996	1997	1998
				Prog.	Est.				Projections			
Exports	51.3	54.5	64.6	67.2	65.5	72.8	83.5	98.4	111.5	131.5	146.7	163.6
Convertible	41.8	47.2	55.3	59.1	62.0	69.3	80.0	94.9	108.1	128.0	143.2	160.1
Nonconvertible	9.6	7.3	9.4	8.2	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Imports	152.7	169.8	195.5	229.0	209.6	256.5	276.8	294.0	316.8	342.5	366.5	386.1
Convertible	108.0	135.7	163.3	209.0	205.0	256.5	276.8	294.0	316.8	342.5	366.5	386.1
Nonconvertible	44.7	34.1	32.2	20.0	4.6	--	--	--	--	--	--	--
Services (net)	-11.8	-4.1	-3.3	-15.4	-9.8	-8.6	-9.4	-10.2	-13.0	-15.9	-18.0	-19.5
Private transfers	6.7	8.3	10.9	10.4	20.4	22.0	23.5	26.0	27.5	28.2	30.0	31.0
Current account (excluding official transfers)	-106.1	-111.1	-123.3	-166.8	-133.5	-170.3	-179.3	-179.8	-190.8	-198.7	-207.8	-211.0
Official transfers	54.3	63.8	57.5	57.5	68.9	75.9	81.0	89.0	96.0	104.0	106.0	108.0
Capital account (net)	59.5	78.7	75.0	99.1	54.1	97.1	104.2	96.8	101.3	105.5	109.6	113.7
Long-term loans (net)	...	48.5	45.1	71.1	36.6	77.1	77.2	65.8	66.3	65.5	67.6	69.7
Convertible area	(15.5)	(38.3)	(43.7)	(71.2)	(38.9)	(80.6)	(80.7)	(69.3)	(69.8)	(69.0)	(71.1)	(73.2)
Nonconvertible area	(19.3)	(10.2)	(1.4)	(-0.1)	(-2.3)	(-3.5)	(-3.5)	(-3.5)	(-3.5)	(-3.5)	(-3.5)	(-3.5)
Direct investment	4.5	7.3	12.8	12.0	15.0	20.0	27.0	31.0	35.0	40.0	42.0	44.0
Commodity credit (nonconvertible area)	15.5	22.9	17.1	12.0	2.5	--	--	--	--	--	--	--
Errors and omissions <sup>2/</sup>	-7.5	-12.6	9.9	4.0	-7.3	--	--	--	--	--	--	--
Overall balance	-4.5	18.8	19.1	-10.2	-17.8	2.7	6.0	6.0	6.6	10.7	7.8	10.8
Net Fund credit	...	7.5	--	12.2	11.8	8.2	--	--	-1.6	-2.7	-3.8	-3.8
Foreign exchange (-, increase)	4.5	-26.3	-19.1	-2.0	6.0	-10.9	-6.0	-6.0	-5.0	-8.0	-4.0	-7.0
Memorandum items:												
Gross reserves <sup>3/</sup>												
(in millions of U.S. dollars)	16.7	42.0	61.1	60.0	55.1	66.0	72.0	78.0	83.0	91.0	95.0	102.0
(in weeks of imports)	5.7	12.9	16.2	13.6	13.7	13.4	13.5	13.8	13.6	13.8	13.5	13.7
Current account/GDP	-19.5	-14.8	-14.3	-16.2	-12.9	-14.7	-14.2	-12.9	-12.3	-11.6	-11.2	-10.3
Debt service ratio <sup>4/</sup>	20.0	17.4	15.2	14.6	15.7	14.7	13.7	12.3	12.6	12.0	12.0	11.5
Nonscheduled debt service/total debt service	49.4	49.8	49.6	49.0	49.0	50.6	52.8	54.8	60.3	63.8	66.3	66.3
Medium- and long-term debt (in percent of GDP) <sup>5/</sup>	38.0	35.8	35.5	...	32.8	36.9	40.0	41.1	41.7	41.6	41.3	40.9

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

<sup>1/</sup> Nonconvertible currency values are converted into dollars at an exchange rate of rub 2.2 = \$1.

<sup>2/</sup> Including short-term private capital flows.

<sup>3/</sup> Includes commercial bank reserves.

<sup>4/</sup> As a ratio of exports of goods and nonfactor services.

<sup>5/</sup> Includes SAF loan; excludes debt to the nonconvertible area of rub 880 million in 1991.

commercial banks; official reserves, held at the Central Bank, are projected to remain at about 2 months of imports.

For the medium term, export earnings are expected to continue their sound growth, rising at an average annual rate of 15 percent in response to improved trade incentives and inflows of foreign investment into export-oriented industries. The bulk of the expansion would come in nontraditional products, as log and wood product exports will be constrained by environmental factors. Following the initial acceleration in 1992, imports are expected to grow at a slower pace, so that the current account deficit would decline steadily to under 12 percent of GDP in 1996. Foreign aid disbursements, a significant part of which relate to ongoing, multi-year projects, are expected to remain buoyant in 1993, although their growth will taper off slightly in later years. The favorable response of bilateral donors to the authorities' reform program suggests that official transfers will remain high, although a tapering off in their growth is assumed over the medium term.

The staff argued that the authorities' target of maintaining the level of total reserves should be regarded as a minimum. Indeed, a further build-up might be warranted since, as the financial reforms progress, commercial bank reserves will not be available for general balance of payments management purposes. The comparatively large loan disbursements would raise the ratio of convertible area debt/GDP from 33 percent in 1992 to 42 percent in 1996, but given highly concessional terms, the debt service ratio, including debt service to the nonconvertible area, would decline from 15 percent in 1992 to 12 percent in 1996.

An alternative balance of payments scenario was prepared by the staff to assess the impact of a less favorable environment on Lao P.D.R.'s external position. Specifically, total exports are assumed to grow at 9 percent per annum, the average rate over the last three years, while access to foreign savings is projected to be one fifth lower than assumed in the baseline scenario. In this setting, the public investment program, which is heavily import-oriented and foreign-financed, would be constrained, but it is assumed that the structural reforms are continued, leading to unchanged levels of private transfers and direct investment. The significant reduction in infrastructure investment would lower economic growth by about 2 percentage points, but the debt and debt service profile would not be affected significantly (Table 7).

Lao P.D.R.'s track-record of payments to the Fund is satisfactory and, since the introduction of arrangements for the advance acquisition of SDRs, previous minor technical delays in payments have ceased. SAF loan repayments and other Fund obligations would absorb a maximum of 3 percent of export earnings in any year. Based on the above, the staff regards the Lao P.D.R.'s capacity to repay the Fund as reasonably assured.

Table 7. Lao P.D.R.: Alternative Balance of Payments  
Scenarios, 1992-96

(In percent, averages 1/)

	1992-96	
	Baseline scenario	Alternative scenario
Export value growth	15	9
Import value growth	10	6
Gross reserves <u>2/</u> In weeks of imports	14	14
Current account/GDP <u>3/</u>	13	11
Debt service ratio <u>4/</u>	13	14
Medium-and long-term debt <u>5/</u> In percent of GDP	42	38
Real GDP growth	6	4

Source: Staff projections.

1/ Except when otherwise indicated.

2/ Includes commercial bank reserves.

3/ Excluding grants.

4/ As a ratio of exports of goods and nonfactor services.

5/ Includes SAF loan; end of period ratio.

## VI. Staff Appraisal

Recent developments in the Lao economy demonstrate that a stable macroeconomic environment is of crucial importance to encouraging an early response of output and investment to systemic reforms. The loss of some traditional levers of economic policy during the first stage of the shift to a market-based economy caused a massive acceleration in inflation. However, beginning in mid-1989, the authorities acted decisively to reduce the growing financial imbalances through tight constraints on new credit to state enterprises, positive real interest rates, and fiscal consolidation. These policies were continued in 1991 and have already reaped considerable success. Inflation has declined dramatically, the nonagricultural sector has begun to respond buoyantly to the reforms, and the external position remains manageable. These achievements are all the more impressive in light of the sudden loss of virtually all aid from and trade with the former Soviet Union. A substantial increase in assistance from other bilateral and multilateral sources greatly helped Lao P.D.R. through this difficult transitional phase.

The authorities' medium-term program is aimed at consolidating the macroeconomic stabilization while further improving the working of the market economy. A crucial element of the proposed strategy will be the strengthening of central macroeconomic institutions. In particular, there is an urgent need to formulate a country-wide consolidated budget, to establish a national Treasury administration, and to complete the centralization of tax collection and expenditure control systems. A comprehensive program of technical assistance will be needed to support these efforts. The authorities' proposals to prune further the oversized civil service and to use the savings for an increase in the present, excessively low, wage rates are an important element of the overall administrative reform.

The financial program for 1992 sets appropriately tight targets for money and credit expansion, but the authorities should be prepared to lower these targets if signs emerge indicating that the rapid GDP growth being envisaged may not occur. The authorities' approach of phasing out the more direct instruments gradually over the current transitional phase is reasonable, given the crucial importance of maintaining progress toward macroeconomic stability. Interest rate guidelines have proved a useful means of encouraging the maintenance of positive real rates, but the minimum lending rates for different economic sectors should be unified at an early stage of the planned shift to full market-determination of interest rates.

The authorities' recent decision to expand the privatization process greatly increases the potential scope for a dynamic private sector. More formal procedures for appraising proposals are also welcome as a means of ensuring that the Government receives an adequate price for its assets, but should not be allowed to become a source of bureaucratic delay. Another point to be kept in mind is that receipts from the sale and lease of assets are not a permanent source of budgetary revenue. Although the authorities, in principle, are correct in their assessment that a system of wage guide-

lines would not be workable and would interfere with the development of an efficient labor market, a continued close monitoring of credit to state enterprises will be needed to prevent an escalation of wages in the run-up to privatization. Moreover, the proposed introduction of a minimum wage rate could put upward pressure on the entire wage structure and is, therefore, not appropriate in the present circumstances.

During the last several years, Lao P.D.R. has pursued a combination of a flexible exchange rate arrangement, involving the maintenance of a close link between the official and parallel market rates, and tight financial policies that have kept the exchange rate broadly stable in practice. The benefits of this stability, in terms of increased confidence in the domestic financial system and the Government's economic policies, have been considerable. Looking ahead, in light of the planned further liberalization of the trade system, which could lead to shifts in the underlying equilibrium of the exchange market that might be difficult to address through monetary policy alone, the authorities are correct to maintain the present flexible arrangements for a further transitional period. Beyond the transitional period, the staff sees considerable advantage in pegging the kip to an appropriate currency basket, in order to consolidate confidence in the currency and provide a guidepost for the continuation of restrained monetary policies.

Medium-term prospects appear to be generally favorable, provided that appropriate domestic policies continue to be implemented and the policies designed to promote increased integration into the world economy (and hence the growth and diversification of exports) are pursued vigorously. However, with one of the lowest per capita incomes in Asia and extremely weak economic and social infrastructure, Lao P.D.R. will continue to need substantial concessional assistance. The 1992 program provides for the maintenance of the current level of foreign reserves in relation to imports. A further buildup in official reserves may be warranted over the medium term as a cushion against external shocks. Lao P.D.R.'s Fund obligations would absorb only a small share of its foreign exchange receipts.

Lao P.D.R. maintains exchange restrictions subject to approval under Article VIII, Section 2(a) in the form of a requirement of prior authorization by the Ministry of Commerce for invisible payments and a limit on travel allowances. In addition, a multiple currency practice subject to approval under Article VIII, Section 3 arises from its tolerance of the parallel exchange market. While recognizing that the exchange system is still in a transitional phase, the staff urges the authorities to direct future exchange reforms toward the removal of these restrictions. In light of the lack of progress since the last consultation in reducing reliance on the multiple currency practice and exchange restrictions and in the absence of a firm timetable for their removal, the staff does not recommend approval of either the multiple currency practice or the exchange restrictions. Lao P.D.R. no longer maintains bilateral payment arrangements with Fund members.

Lao P.D.R. has been placed on the standard 12-month cycle. Accordingly, the next Article IV consultation will be completed within 12 months of completion of the present consultation.

VII. Proposed Decision

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

1. The Government of Lao P.D.R. has requested the third annual arrangement under the structural adjustment facility.
2. The Fund has appraised the progress of Lao P.D.R. in implementing the policies and reaching the objectives of the program supported by the second annual arrangement, and notes the updated policy framework paper (EBD/92/47, 3/11/92).
3. The Fund approves the arrangement set forth in EBS/92/58.



Lao P.D.R.: Fund Relations

(As of February 28, 1992)

- I. (a) Date of membership: 1961  
(b) Status: Article XIV

A. Financial Relations

II. General Department

- (a) Quota: SDR 29.3 million  
(b) Total Fund holdings of kip: SDR 29.3 million  
(100 percent of quota)  
(c) SAF loans outstanding SDR 14.65 million  
(d) Fund credit: SDR 14.65 million  
(e) Reserve tranche position: None  
(f) Current operational budget: Not included  
(g) Lending to the Fund: None

III. Current stand-by or extended arrangement and special facilities

- (a) Current arrangement: None  
(b) Previous stand-by and extended  
arrangements during the last  
ten years: Stand-by arrangement,  
Aug. 1980-Aug. 1981 of  
SDR 14 million, or  
87.5 percent of quota.  
The amount was fully  
repurchased.  
(c) Special facilities during  
the past two years: None

IV. SDR Department

- (a) Net cumulative allocation: SDR 9.41 million  
(b) Holdings: SDR 0.18 million  
(c) Current designation plan: Not included

V. Administered accounts

- (a) Trust Fund loans  
(i) Disbursed: SDR 12.7 million  
(ii) Outstanding: None  
(b) SFF subsidy account: None

VI. Financial obligations due to the Fund

There are no overdue obligations. Table 1 shows the projected payments to the Fund on the assumption that the third-year loan under the SAF would be disbursed in April 1992.

B. Nonfinancial Relations

VII. Exchange rate

In September 1987, Lao P.D.R. unified all rates, at KN 350 (buying) and KN 385 (selling) per U.S. dollar. The exchange rate subsequently has been adjusted in line with movements in the parallel market rate. On December 31, 1991, the official exchange rate was KN 711 (buying) and KN 712 (selling) per U.S. dollar. The representative rate, which is the rate on the basis of which the SDR/kip rate used to value transactions with the Fund is established, is KN 577 per U.S. dollar which was the rate on June 29, 1989.

VIII. Last Article IV consultation discussions

The last Article IV consultation discussions were held in Vientiane during May 3-20, August 2-12 and September 16-20, 1990. The staff report (SM/90/211) was discussed by the Executive Board on November 28, 1990.

IX. Technical assistance

The IMF institute conducted seminars on Financial Analysis and Policy in Vientiane in June 1987 and April 1990. An STA mission visited Lao P.D.R. in October-November 1988 to provide technical assistance in money and banking statistics and in November-December 1988 to assist in the compilation of balance of payments data. A CBD mission with participation from LEG visited Lao P.D.R. in August 1989 to advise on a new Central Bank Law. A CBD expert was assigned as a General Advisor on central banking matters during 1989-91. A CBD mission visited Lao P.D.R. in September 1991 to advise on foreign reserves management. FAD missions visited Lao P.D.R. in June-July 1989, January-February 1990 and in October-November 1991 to provide technical assistance in tax policy and administration. Two FAD panel members are currently assigned to the Ministry of Economy, Plan and Finance in the areas of tax and customs administration.

Table 1. Lao P.D.R. - Projected Payments to the Fund

(In millions of SDRs)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Remaining period	Total
A. Obligations from outstanding use of resources												
1. Principal	--	--	--	--	1.17	2.05	2.93	2.93	2.93	1.76	0.88	14.65
ESAF/SAF repayments	--	--	--	--	--	--	--	--	--	--	--	--
2. Charges and interest <sup>1/</sup>	0.20	0.70	0.70	0.70	0.70	0.69	0.68	0.67	0.65	0.64	--	6.33
Total	0.20	0.70	0.70	0.70	1.87	2.74	3.61	3.60	3.58	2.40	0.88	20.98
(Percent of quota)	0.7	2.4	2.4	2.4	6.4	9.4	12.3	12.3	12.2	8.2	3.0	71.6
B. Obligations from prospective use of resources												
1. Principal	--	--	--	--	--	--	0.59	1.17	1.17	1.17	1.76	5.86
ESAF/SAF repayments	--	--	--	--	--	--	--	--	--	--	--	--
2. Charges and interest <sup>1/</sup>	--	0.03	0.03	0.03	0.03	0.03	0.03	0.02	0.02	0.01	--	0.23
Total	--	0.03	0.03	0.03	0.03	0.03	0.62	1.19	1.19	1.18	1.76	6.09
(Percent of quota)	--	0.1	0.1	0.1	0.1	0.1	2.1	4.1	4.1	4.0	6.0	20.8
C. Cumulative (outstanding and prospective)												
1. Principal	--	--	--	--	1.17	2.05	3.52	4.10	4.10	2.93	2.64	20.51
ESAF/SAF repayments	--	--	--	--	--	--	--	--	--	--	--	--
2. Charges and interest <sup>1/</sup>	0.20	0.73	0.73	0.73	0.73	0.72	0.71	0.69	0.67	0.65	--	6.56
Total	0.20	0.73	0.73	0.73	1.90	2.77	4.23	4.79	4.77	3.58	2.64	27.07
(Percent of quota)	0.7	2.5	2.5	2.5	6.5	9.5	14.4	16.3	16.3	12.2	9.0	92.4

<sup>1/</sup> Projections are based on current rates of charge, including burden-sharing adjustments where applicable, for purchases in the GRA; current interest rates for ESAF/SAF and Trust Fund; and current SDR interest rate for net use of SDRs.

Lao P.D.R.: Fund Relations (concluded)

X. Resident Representative/Advisor: Mr. C.D. Pham took up the post of resident representative in October 1990.

XI. Present consultation cycle: Annual.

Lao P.D.R.: Relations with the World Bank Group

The World Bank operations support the country's adjustment program and the development of a more efficient system of infrastructure. All projects are financed with IDA credits. Two credits for road rehabilitation projects (\$14.1 and \$45.0 million) were signed in December 1987 and March 1991. An industrial credit project (\$10 million) was approved in August 1988 and the establishment of a National Polytechnic Institute (\$3 million or \$16 million, including co-financing) was approved in April 1988. Two IDA structural adjustment credits, each of \$40 million, were approved on June 9, 1989 and October 1, 1991. An upland agriculture development project (\$20.2 million) was approved in December 1989, and in March 1990 the second telecommunications project (\$24.5 million) was approved.

As requested by the Government, the Bank intends to place increased emphasis on human resource development in its new commitments in addition to its already broad role in basic infrastructure and productive sectors. Since 1978, the amount of IDA credits committed and disbursed has been as follows:

IDA: Commitments and Disbursements to Lao P.D.R., CY 1978-91

(In millions of U.S. dollars; as of December 31, 1991)

	Committed	Disbursed	Repayments
1978	8.2	0.10	--
1979	10.4	0.24	--
1980	13.4	5.29	--
1981	15.0	5.42	--
1982	--	3.18	--
1983	6.2	1.94	--
1984	--	9.99	--
1985	--	4.97	--
1986	3.9	6.96	--
1987	39.9	4.95	--
1988	10.0	10.13	0.08
1989	63.7	35.13	0.14
1990	24.5	32.59	0.25
1991	85.0	14.61	0.32
Total	<u>240.2</u>	<u>131.96</u>	<u>0.79</u>

Source: World Bank.

Note: The last Country Economic Memorandum (Lao P.D.R.: Issues in Public Economics, Report No. 7188-LA) was published on August 10, 1990.

Lao People's Democratic Republic  
Third Annual Arrangement Under  
the Structural Adjustment Facility

Attached hereto is a letter dated February 29, 1992 and a Memorandum of Economic and Financial Policies from the Government of the Lao People's Democratic Republic, requesting from the Fund the third annual arrangement under the three-year structural adjustment arrangement, and setting forth the objectives and policies of the program to be supported by the third annual arrangement.

To support these objectives and policies, the International Monetary Fund grants the requested arrangement in accordance with the following provisions and subject to the regulations for the Administration of the Structural Adjustment Facility.

1. The third loan, in an amount equivalent to SDR 5.86 million, is available for disbursement at the request of the Lao People's Democratic Republic.

2. The progress of the Lao People's Democratic Republic in implementing the policies and reaching the objectives of the program supported by the third annual arrangement will be appraised, taking into account primarily:

- (a) the benchmarks specified in Tables 1 and 2 attached to the Memorandum on Economic and Financial policies;
- (b) imposition or intensification of restrictions on payments and transfers for current international transactions;
- (c) introduction or modification of multiple currency practices;
- (d) conclusion of bilateral payments agreements which are inconsistent with Article VIII;
- (e) imposition or intensification of import restrictions for balance of payments reasons.

3. In accordance with paragraph 4 of the attached letter, the Lao People's Democratic Republic will provide the Fund with such information as the Fund requests in connection with the progress of the Lao People's Democratic Republic in implementing the policies and reaching the objectives supported by the third annual arrangement.

4. In accordance with paragraph 5 of the attached letter, the Lao People's Democratic Republic will consult with the Managing Director on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because he considers that consultation on the program is desirable. These consultations may include correspondence and visits of officials of the Fund to the Lao People's Democratic Republic or of representatives of the Lao People's Democratic Republic to the Fund.

Vientiane  
Lao People's Democratic  
Republic

February 29, 1992

Dear Mr. Camdessus:

1. On behalf of the Government of the Lao People's Democratic Republic, we are pleased to transmit herewith an updated policy framework paper for the period 1992-94 prepared in collaboration with the staffs of the International Monetary Fund and the World Bank. The paper describes the recent progress made in consolidating macroeconomic stability and implementing market-oriented reforms; the objectives of the Government's medium-term adjustment program; the broad thrust of financial, external, and structural policies; and the likely external financing requirements and prospects. We are forwarding today the same policy framework paper to the President of the World Bank.

2. To facilitate a wider distribution of the policy framework paper within the donor community, the Government of the Lao People's Democratic Republic authorizes you, at your discretion, to transmit the document to any national or international organization providing or likely to provide assistance to the Lao People's Democratic Republic.

3. A Memorandum of Economic and Financial Policies, which sets out the objectives and policies that the Government plans to pursue during 1992, is also attached. In support of these objectives and policies, the Lao People's Democratic Republic hereby requests from the Fund the third annual arrangement under the structural adjustment facility (SAF).

4. The Lao People's Democratic Republic will provide the Fund with such information as the Fund requests on the progress in policy implementation and the achievement of the program objectives.

5. The Lao People's Democratic Republic will consult with the Managing Director of the Fund on the adoption of any additional policy



measures that may be appropriate at our own initiative or whenever the Managing Director requests such consultation.

Sincerely yours,

Pany Yathotou  
Governor  
Bank of the Lao People's  
Democratic Republic

Khamphoui Keoboualapha  
Deputy Prime Minister  
and  
Minister of Economy,  
Plan and Finance

Attachments: Annexes (1) Policy Framework Paper, 1992-94  
(2) Memorandum of Economic and Financial  
Policies of the Lao People's  
Democratic Republic for 1992

Mr. Michel Camdessus  
Managing Director  
International Monetary Fund  
700 19th Street, N.W.  
Washington, D.C. 20431  
U.S.A.

Memorandum of Economic and Financial Policies  
of the Lao People's Democratic Republic for 1992

I. The First and Second-Year SAF-Supported Programs 1/

1. The Lao P.D.R. has been implementing since mid-1989 a medium-term adjustment program aimed at restoring macroeconomic stability while continuing the transformation from a centrally planned into a market-oriented economic system. An initial round of economic liberalization, including decontrol of most prices, was followed by a surge of inflation in 1989 as a result of deteriorating government revenues and rapid expansion in bank credit to public enterprises. A major goal of the medium-term program has been to bring inflation down by tightening financial policies so as to create a stable macroeconomic environment for structural reforms. These reforms included: (i) promotion of the private sector through privatization of about one sixth of all public enterprises; (ii) greater mobilization of public resources through a tax reform and strengthened administration; (iii) reorientation of public expenditures from direct intervention in production toward the provision of basic physical and human infrastructure; (iv) establishment of a two-tier banking system and development of new instruments of monetary control; and (v) broadening of access to imports and opportunities to export for the private sector through liberalization of the trade system.

2. Macroeconomic objectives of the second-year SAF-supported program, covering the calendar year 1991, were broadly attained. Real GDP growth of an estimated 4 percent resulted from buoyant manufacturing and construction that compensated for a weather-induced shortfall in agricultural production. Revenues equal to about 11 percent of GDP 2/ exceeded program targets despite a temporary delay in implementing new excise taxes and the postponement of some other tax measures (a minimum corporate income tax and an alternative tax on small businesses); the good performance reflected the ongoing centralization of tax collection procedures. Current expenditures were broadly as programmed, but the pace of implementation of capital projects was slower than expected owing to delays in the commencement of several large projects. The overall deficit (excluding grants) fell from over 14 percent of GDP in 1990 to an estimated 10 percent of GDP in 1991. Temporary delays in disbursements under some foreign program loans until

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1/ A more detailed description is provided in the Policy Framework Paper (PFP) for 1992-94.

2/ Since the 1991 program was formulated, revised national income accounts have been prepared that are significantly higher than the earlier series. Program targets in terms of GDP have been revised in line with this new series.

early 1992 led to bank financing to the budget of KN 10.5 billion, substantially in excess of the program benchmark. Domestic liquidity rose by an estimated 10 percent, as tight monetary policies continued to constrain credit, especially to public enterprises. Interest rates remained substantially positive in real terms. The inflation rate declined to 10.4 percent by end-1991, and the parallel and official exchange rates, which differed from each other by less than 3 percent, continued to be stable. Exports to the convertible area rose by about 12 percent, but total exports showed little growth because of a sharp decline in trade with the nonconvertible area. Total imports grew by an estimated 7 percent, significantly less than programmed owing to lower oil prices and the shortfall in public investment. Although an increase had been expected, the current account deficit (excluding grants) fell moderately to under 13 percent of GDP. With the shortfall in foreign financing, the overall deficit widened to \$17.8 million resulting in a drawdown of gross foreign reserves to \$55 million (13.7 weeks of imports) by end-1991 compared with a program target of \$60 million. <sup>1/</sup> With the disbursement of some delayed program loans in early 1992, reserves have since risen to about \$62 million at end-January 1992.

## II. Third-Year SAF-Supported Program

3. The Government has updated the PFP to cover the 1992-94 period. The broad economic strategy remains unchanged, although a substantial acceleration of the privatization process is now envisaged. Within the revised medium-term framework, major objectives for the third-year program, for calendar 1992, are real GDP growth of 6-7 percent; a decline in inflation to 6-7 percent by end-December 1992, equivalent to 8-9 percent on an annual average basis; and the maintenance of foreign reserves at 13-14 weeks of imports. The attainment of these objectives would be facilitated by a return of normal weather and continued inflows of concessional external assistance, but appropriate financial and external policies will be crucial. Moreover, the Government is aware that sustaining such policies over the medium term will require a considerable further strengthening of macro-economic institutions, most notably in the areas of revenue collection, fiscal management, and macroeconomic statistics.

### a. Fiscal policies

4. The 1992 budget will be set within the centralized framework of fiscal management described in paragraph 19 of the PFP. The budget provides explicit appropriations of KN 200 million for the establishment and effective operation of a national Treasury administration by June 1992.

5. The current balance (excluding grants) of the budget is targeted to move into a surplus 0.6 percent of GDP, supported by an increase in revenues equivalent to 1 percent of GDP and current spending that remains

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<sup>1/</sup> Including reserves of the commercial banks; reserves of the Central Bank only amounted to about \$30 million (eight weeks of imports).

broadly unchanged at just over 11 percent of GDP. The revenue performance will be improved by the full-year impact of the excise taxes introduced in mid-1991, and by the application of new taxes on property transfers and inheritances as well as a wide range of user fees. Government receipts from the sale of state enterprise assets have been conservatively estimated at 0.8 percent of GDP, only a moderate increase from 1991. By July 1992, the Government also plans to introduce a minimum duty of 5 percent on all imports previously benefiting from exemptions (other than those exempt by international agreement), to tighten procedures for granting exemptions, and to implement the GATT valuation system for assessing the dutiable base. At the same time, action will be taken to ensure that all businesses pay some tax in the form of a minimum corporate tax (or a substantial increase in business license fees), and a simplified tax on small businesses will also be introduced. The system of timber royalties is being reviewed with World Bank technical assistance, and the Government expects to develop a new system by October 1992. Tax administration has already improved significantly, largely as a result of the centralization of revenue collection, but tax enforcement needs further strengthening. The Government intends to establish explicit follow-up and control procedures for customs and direct taxes and to staff special tax enforcement units. Revenues will be monitored through quarterly benchmarks and additional measures will be taken, if necessary, to meet the program targets.

6. As the first stage of a major retrenchment program, the Government plans in 1992 to lay off some 10,800 employees (15 percent of all civil service staff). One fifth of the resulting savings will be used to hire new staff in priority areas (e.g., for the establishment of a Treasury and the strengthening of tax and customs administration) and the rest of the savings will be used to raise civil service wage scales. Thus, the nominal wage bill will not increase, apart from the provision of severance payments, which will amount to about 0.5 percent of GDP in 1992. A significant part of the substantial increase for materials and supplies will be earmarked for health and education and special programs in remote areas. However, part of this allocation will be retained in a central fund and released only if revenues attain their targeted levels. The recentralization of fiscal management has revealed that the backlog of arrears is larger than previously envisaged, and a further net repayment of KN 4 billion has been programmed for 1992. Now that several large foreign-financed projects have commenced, a significant pick-up in the rate of project implementation is projected. Capital expenditures are projected to rise by 21 percent, reaching 9.5 percent of GDP; most of the expansion will be in infrastructure construction, health, and education.

7. As the foreign financing for 1992 includes a portion of the program loan disbursements delayed from the previous year, the Government plans to partially replenish its deposits with the banking system. Therefore, bank financing of the budget will be negative by KN 5.8 billion.

b. Monetary policies

8. Monetary policies will be directed toward consolidating the recent gains in financial stability. Taking into account the output and inflation targets of the program, nominal money demand is projected to grow by about 13 percent. <sup>1/</sup> Credit targets have been derived after taking account of the desired improvement in external reserves. Total credit to the nongovernment sector would rise by about 26 percent. Reflecting the planned acceleration in privatization, credit to public enterprises is projected to be flat and credit to the private sector is targeted to rise by 80 percent, albeit from a very small base.

9. The Central Bank will increase its reliance on indirect monetary policy instruments. A 5 percent minimum reserve requirement on commercial bank deposits has already been introduced and will be adjusted, as appropriate, in light of monetary developments. A system of penalties will be enforced for non-compliance. To meet their temporary liquidity needs, the banks have the option to use the new formal credit window opened by the Central Bank. The Bank will also continue to issue its own securities to be used in developing open market operations.

10. The Government will allow the banks to set their own interest rates during 1992, subject only to Central Bank guidelines on minimum deposit and loan rates. These guidelines will be reviewed regularly to ensure that they remain positive in real terms. The Central Bank will continue to keep its interest rate on credit to commercial banks above the projected inflation rate.

c. External sector outlook and policies

11. The balance of payments outlook for 1992 is generally favorable. Total exports are projected to grow by about 11 percent; a decline in forestry exports resulting from the continuing ban on timber cutting is expected to be more than offset by the strong response, albeit from a small base, in exports of agricultural and nontraditional products (e.g., garments) to the new opportunities created by the reforms. Imports are projected to rise by 22 percent, largely because of the expected increase in public investment expenditure. The current account deficit (excluding official transfers) is projected to rise to 14.8 percent of GDP. However, aid disbursements, including program loans originally expected in 1991, are projected to be sharply higher. Moreover, the economic reforms, and especially the privatization program, have begun to attract increased inflows of foreign direct investment. Therefore, the overall balance of payments is expected to record a small surplus.

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<sup>1/</sup> The money and credit targets do not include the activities of the Joint Development Bank, which is expected to be incorporated in the monetary survey during 1992.

12. Exchange rate policy will remain unchanged in 1992, and the official exchange rate will be kept within a 10 percent differential of the parallel market rate. The Government regards the present level of the exchange rate as providing adequate incentives for export growth and diversification. However, it will continue to monitor the level of foreign exchange reserves, underlying cost and price developments, and other indicators for assessing the appropriate level of the official exchange rate and the overall stance of financial policies.

13. The Government will continue its cautious external debt policy. During 1992 the public sector will not contract or guarantee short-term borrowing except for normal import-related credits and will not contract or guarantee medium- and long-term nonconcessional debt with initial maturities from 1 to 12 years in excess of a cumulative \$5 million.

d. Improvements in statistics

14. Recognizing that timely, accurate, and comprehensive macroeconomic statistics are essential for effective economic management, the Government intends to develop an action plan to correct the present weaknesses in fiscal, monetary, and balance of payments statistics. A multi-topic statistics mission from the IMF is scheduled for May 1992 to assist in identifying the major problems and in developing the action plan.

e. Structural reforms

15. Privatization of public enterprises will be accelerated in line with the policies described in paragraph 24 of the PFP. The timetable for 1992 calls for specific privatization proposals for all enterprises controlled by the ministries of agriculture and industry to be submitted to the Privatization Committee by June 1992, and for all others to be submitted by end-1992. Targets agreed with the World Bank as part of the Second Structural Adjustment Credit provide for the privatization (by direct sale or share issuance) of at least 25 larger (i.e., with over 30 employees) enterprises in 1992.

16. During 1992, the financial sector reform is expected to gain further momentum. With AsDB technical assistance, a comprehensive survey of commercial banks' asset portfolios will be undertaken to determine the extent of bad and doubtful debts; the results will serve as a basis for asset restructuring and recapitalization. Moreover, within the framework of its privatization program, the Government will pursue options for private equity participation in some publicly owned commercial banks. The Government also intends to encourage the establishment of new private commercial banks to promote further competition.

17. The Government's objective is an open trading system free of quantitative restrictions. The present liberalized trade regulations, which were introduced in February 1991, still provide for quantitative

restrictions on a small number of export and import items. <sup>1/</sup> However, licenses on many of these goods are only required as a means of enforcing tax or environmental regulations (e.g., for timber exports) or to monitor supplies (e.g., petroleum imports); all legitimate applications for trade in such items are granted. In addition, restrictions on livestock exports have recently been relaxed. The Government is also reviewing the remaining quantitative licensing requirements (for rice, cement, motor vehicles, and reinforced steel wires) with the intention of replacing them by higher import tariffs by the end of the year.

### III. Monitoring and Review

18. The Government has established a number of benchmarks to enable it to monitor developments under the program. Table 1 shows the benchmarks for policy implementation in five areas: (i) fiscal administration; (ii) civil service reform; (iii) interest rate policy; (iv) exchange rate policy; and (v) economic and financial statistics. Quantitative benchmarks will be as detailed in Table 2.

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<sup>1/</sup> The list of commodities is contained in paragraph 12 of the PFP.

Table 1. Lao P.D.R.: Proposed Benchmarks for Policy Implementation  
Under the Structural Adjustment Facility, 1992

Benchmark	Measure
1. Fiscal management	Submit to the Supreme People's Assembly by end-March 1992 the Budget for 1992 consistent with the new framework of centralization and including the appropriations for the national Treasury specified in paragraph 4.
2. Civil service reform	Lay off 10,800 civil servants by end-December, and hold the total government wage bill for 1992, other than severance payments, unchanged at its 1991 level.
3. Interest rates	Continue to set the lending rate of the Central Bank at a positive level in real terms in comparison with projected inflation. Issue guidelines to the commercial banks indicating the minimum interest rate to be paid by commercial banks on one-year time deposits. <u>1/</u>
4. Exchange rate policy	Maintain the difference between the official and parallel market rates below 10 percent through December 1992.
5. Economic and financial statistics	Prepare an action plan by end-September 1992 to improve monetary, fiscal, and balance of payments statistics.

1/ Benchmark to be in effect throughout the year. The projected inflation rates will be reassessed on a quarterly basis.



Table 2. Lao P.D.R.: Proposed Quantitative Benchmarks for the Third Annual Arrangement of the Structural Adjustment Facility, 1992

	1992			
	March	June	Sept.	Dec.
(In billions of kip)				
1. Net domestic assets <u>1/</u> <u>2/</u> (cumulative flow) <u>3/</u> <u>4/</u>	-3.8	-0.8	2.4	5.1
2. Net credit to Government (cumulative flow) <u>3/</u> <u>4/</u>	-5.6	-5.3	-4.6	-5.8
3. Government revenues from taxes (cumulative flow) <u>5/</u>	12.8	30.1	46.4	69.7
(In millions of U.S. dollars)				
4. Gross international reserves (stock at end of period) <u>6/</u>	63	70	68	66
5. New nonconcessional external loans contracted or guaranteed by the public sector (cumulative on a 12-month basis)				
a. 1-12 years <u>7/</u>	5	5	5	5
b. Less than 1 year <u>8/</u>	--	--	--	--

1/ Net domestic assets of the banking system are defined as the difference between the stock of bank liquidity (M2) and net foreign assets, excluding the valuation impact of exchange rate changes.

2/ Excluding any effects of the prospective recapitalization of commercial banks.

3/ Cumulative flows measured from the actual stock outstanding at end-December 1991.

4/ These benchmarks are subject to upward (or downward) adjustment by the full amount of the total cumulative shortfall (or excess) in foreign program loans to the budget.

5/ Corporate, agricultural and personal income taxes; turnover and sales taxes; international trade taxes; natural resource and land taxes; and user fees (registration, stamp, motor vehicle and other fees).

6/ This benchmark is subject to an upward (or downward) adjustment by the full amount of the total cumulative excess (or shortfall) in foreign program loans.

7/ Excluding the finalization of a loan contract for the purchase of two airplanes by Lao Aviation.

8/ Excluding normal import-related credits. The stock of these loans was zero at end-1991.

