THE BANKING AND FINANCIAL SECTOR OF LAO PDR

FINANCIAL SECTOR NOTE

15 July 2002

Financial Sector and Industry Division
Infrastructure. Energy & Financial Sector Department (West)
Asian Development Bank

Financial Sector Group
Poverty Reduction & Economic Management Unit
East Asia and Pacific Region
World Bank
CURRENCY EQUIVALENTS
(as of end-June 2002)
US$1 = 9,900 kip

FISCAL YEAR
October 1 to September 30

ABBREVIATIONS AND ACRONYMS

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
</tr>
<tr>
<td>AFTA</td>
<td>Asian Free Trade Area</td>
</tr>
<tr>
<td>AGL</td>
<td>Assurances Générales du Lao</td>
</tr>
<tr>
<td>APB</td>
<td>Agriculture Promotion Bank</td>
</tr>
<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
</tr>
<tr>
<td>BCEL</td>
<td>Banque du Commerce Extérieur Lao</td>
</tr>
<tr>
<td>BIS</td>
<td>Bank of International Settlements</td>
</tr>
<tr>
<td>BOL</td>
<td>Bank of Lao PDR</td>
</tr>
<tr>
<td>CMT</td>
<td>Cut Make and Trim</td>
</tr>
<tr>
<td>CPAs</td>
<td>Certified Public Accountants</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>FOB</td>
<td>Free On Board</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>GTZ</td>
<td>Deutsche Gesellschaft für Technische Zusammenarbeit</td>
</tr>
<tr>
<td>Ha</td>
<td>Hectares</td>
</tr>
<tr>
<td>IAS</td>
<td>International Accounting Standards</td>
</tr>
<tr>
<td>ICOR</td>
<td>Incremental Capital Output Ratio</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>KPMG</td>
<td>Klynveld Peat Marwick Goerdeler</td>
</tr>
<tr>
<td>LWU</td>
<td>Lao Women’s Union</td>
</tr>
<tr>
<td>MCC</td>
<td>Microfinance Coordinating Committee</td>
</tr>
<tr>
<td>MFIs</td>
<td>Microfinance Institutions</td>
</tr>
<tr>
<td>MTF</td>
<td>Microfinance Task Force</td>
</tr>
<tr>
<td>MLSW</td>
<td>Ministry of Labor and Social Welfare</td>
</tr>
<tr>
<td>MOF</td>
<td>Ministry of Finance</td>
</tr>
<tr>
<td>MOFA</td>
<td>Ministry of Foreign Affairs</td>
</tr>
<tr>
<td>NBFIs</td>
<td>Non-bank Financial Institutions</td>
</tr>
<tr>
<td>NEM</td>
<td>New Economic Mechanism</td>
</tr>
<tr>
<td>NPLs</td>
<td>Non-performing Loans</td>
</tr>
<tr>
<td>PDR</td>
<td>People’s Democratic Republic</td>
</tr>
<tr>
<td>PSD</td>
<td>Private Sector Development</td>
</tr>
<tr>
<td>SBL</td>
<td>State Bank of Lao</td>
</tr>
<tr>
<td>SIDA</td>
<td>Swedish International Development Agency</td>
</tr>
<tr>
<td>SME</td>
<td>Small and Medium-sized Enterprises</td>
</tr>
<tr>
<td>SOCBs</td>
<td>State-owned Commercial Banks</td>
</tr>
<tr>
<td>SOEs</td>
<td>State-owned Enterprises</td>
</tr>
<tr>
<td>SSO</td>
<td>Social Security Organization</td>
</tr>
<tr>
<td>UNCDF</td>
<td>United Nations Capital Development Fund</td>
</tr>
<tr>
<td>UNDP</td>
<td>United Nations Development Program</td>
</tr>
<tr>
<td>VRFs</td>
<td>Village Revolving Funds</td>
</tr>
<tr>
<td>WB</td>
<td>World Bank</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organization</td>
</tr>
</tbody>
</table>

This report is a team production. Messrs. Panom Lathouly and Khamphout Sitthilat, successive Deputy Directors of Research at Bank of Lao PDR coordinated the input of the Government. Mrs. S. Hattori and Messrs. E. Manes and V. T. Velasco provided and coordinated inputs from the Asian Development Bank. Mrs. L. Schneider, and Messrs. L. Byadran, E. Duflos (Consultants) and O. Lambert provided and coordinated inputs from the World Bank, and edited the report. The Team is grateful to many colleagues in the Lao Government, ADB (Mrs. J. Daumas and Messrs. B. Coleman, N. Fernando and J. Wynn-Williams, Consultant), IMF (Messrs. H. Shishido, S. Cook and E. Sidgwick), SIDA (Mr. Bourdet), UNDP/UNCDF (The Microfinance Project) and WB (Mrs. G. Ferencz and Messrs. Z. Ahmed, M. Amin, N. Annamalai, L. Chiquier, R. Duncan, E. Haythorne, P. Honohan, P. Keefer, D. Kim, A. Laurin, K. Nordlander) for their valuable contributions. Mrs. A. Bowrin (WB) processed the document.
Foreword

Introduction

Executive Summary

Chapter I. Macroeconomic Issues
   A. Financial Systems and Growth
      1. Some Cross-Country Evidence
      2. Lao PDR’ Growth Objectives: Implications for the Financial System
   B. Financial Systems and Macroeconomic Stability
   C. Importance of Macroeconomic Management
      1. Less resources were available
      2. But Public Investments Remained at a High Level
      3. With Lower Investment Efficiency
      4. Recent Stability Measures

Chapter II. Institutional Analysis
   A. An Historical Perspective
   B. The Ministry of Finance
      1. Responsibility for the Financial Sector
      2. Financing the Budget Deficits
      3. The Accounting Framework
         Company Accounting
         Bank Accounting
         Auditing
         Disclosure
         Government Accounting
   C. The Central Bank
      1. Insufficient autonomy
         Mandate
         Governance Structure
      2. Inefficient Monetary Policy Management
         Dollarization
         Policy Making Process
         Policy Lending
         Financial Situation
      3. Weak Banking Supervision
         Legal and Prudential Framework
         Institutional Building
         Deposit Insurance
      4. Handling Non-Performing Loans
   D. The Legal Framework and Judicial Enforcement
      1. The Constitution
2. The Lao Laws, Decrees and Notices ................................................................................. 21
4. The Judicial Process and Enforcement ............................................................................. 24

Chapter III. Description of the Financial System ................................................................... 26
A. The Banking Market: Small and Dominated By State-Owned Banks ......................... 26
B. Non-Bank Financial Institutions .......................................................................................... 29
1. Microfinance ..................................................................................................................... 29
2. Non-Life and Life Insurance Industry .............................................................................. 31
3. Social Security in Lao PDR .............................................................................................. 32
4. The Leasing Industry in Lao PDR .................................................................................... 33

Chapter IV. Functional Analysis .............................................................................................. 34
A. Introduction .......................................................................................................................... 34
B. Deposits Mobilization and Banks’ Resources ................................................................ 34
1. Deposit mobilization ......................................................................................................... 34
2. Banks’ Resources .............................................................................................................. 36
C. Capital Allocation, Credit Risk and Banks’ Capital ............................................................ 37
1. Capital Allocation and Policy Lending ............................................................................. 38
2. Banks’ Assets .................................................................................................................... 39
3. Credit Risk and Banks’ Capital: Evidence of a Crisis ...................................................... 41
4. Implications ....................................................................................................................... 43
D. Other Functions Of The Financial System ........................................................................... 44
1. Ex-post Corporate Control ............................................................................................... 44
2. Facilitation of Transactions ............................................................................................... 45

Chapter V. Sectoral Analysis .................................................................................................... 47
A. Agricultural sector ............................................................................................................... 47
1. Agriculture: Importance and Issues for the Main Products .............................................. 47
2. Financial Services ............................................................................................................. 48

Demand ........................................................................................................................... 48
Supply ............................................................................................................................. 49
B. Private Sector ....................................................................................................................... 52
1. The Rationale .................................................................................................................... 52
2. International Experience ................................................................................................. 53
3. The Private Sector in Lao PDR ......................................................................................... 54
4. Importance of Adequate Financing: an Illustration ......................................................... 56
5. Role of Lao Government in Private Sector Development ................................................. 58

Governance and Regulations ......................................................................................... 69

Tables
Table 1. Financial Depth: Country Comparison (1997) ........................................................ 3
Table 2. Market Share of Banking Institutions, December 1999 ............................................. 26
Table 3. Banking Sector Development: International Comparison ........................................... 27
Table 4. Structure of Lao banking deposits ............................................................................. 35
Table 5. Composition of Banks’ Deposits .................................................................................... 37
Table 6. Lending Interest Rates of SOCBs (end of February 1999)................................................. 38
Table 7. Size of NPLs in the Lao Banking System (September 1999).............................................. 40
Table 8. Credit risks, Non-performing Loans and Capital Adequacy Consolidated Banking Systems (1998) ............................................................................................................... 42
Table 9. Contribution of the Agricultural Sector ........................................................................... 47
Table 10. Financial Situation of APB ............................................................................................ 51
Table 11. Manufacturing Industrial Sector .................................................................................... 55
Table 12. Major Exports by Industrial Products (1998) ............................................................... 56

**Figures**

Figure 1. Financial Deepening ........................................................................................................ 3
Figure 2. Composition of Broad Money, Lao PDR (Oct-1999) ......................................................... 3
Figure 3. Inflation ............................................................................................................................. 4
Figure 4. Depreciation of the Kip ................................................................................................... 4
Figure 5. FDI and Aid ..................................................................................................................... 6
Figure 6. Fiscal deficit .................................................................................................................... 6
Figure 7. Investment and ICOR (Lao PDR) .................................................................................... 7
Figure 8. GDP Real Growth ........................................................................................................... 7
Figure 9. Recent Inflation Quarterly Rate ....................................................................................... 8
Figure 10. Recent GDP Growth ....................................................................................................... 8
Figure 11. Central Bank Independence and Inflation (1960-92) ..................................................... 14
Figure 12. Size of Financial System (167 Countries) ...................................................................... 27
Figure 13. Costs of Financial Crisis ............................................................................................... 43

**Textboxes**

Box 1. Diagnostic of the Lao Legal and Judicial System ............................................................... 25
Box 2. Joint-Venture Banks and Foreign Branches in Lao PDR ..................................................... 28
Box 3. Typical Microfinance Story ............................................................................................... 31
Box 4. An Example of APB Activity ............................................................................................ 50
Box 5. Creating a Vibrant Enterprise Sector ................................................................................ 57

**Annexes**

Annex 1. Comparison of Current Prudential Guidelines in Lao PDR with the 25 Core Principles for Effective Bank Supervision .......................................................... 60
Annex 2. History of the Lao Banking system ................................................................................. 62
Annex 3. Financial Analysis Of Banque Pour Le Commerce Exterieur Lao .................................. 64
Annex 4. Financial Analysis of Agriculture Promotion Bank .................................................... 69
Annex 5. Microfinance : Estimates of Supply and Demand ......................................................... 74
Annex 6. Description Of Main Agricultural Products .................................................................. 76
FOREWORD

Jointly prepared by the Bank of Lao PDR, the Asian Development Bank and the World Bank, with the collaboration of the Swedish International Development Agency and the United Nations Development Program, this Financial Sector Note represents the first step in a process that aims to engage an in-depth substantive dialogue between the Lao government and the donor community on the policy reforms required to strengthen the Lao financial system. The purpose of this paper is to understand what are the problems faced by Lao PDR and why. This paper is not about what to do on the premise that if there is no common understanding about “what” and “why”, the discussion cannot move on to “what to do”.

This paper’s analysis of the challenges confronting the Lao financial sector is the result of a three-step process. First, based on an initial draft, technical discussions were organized by the Bank of Lao PDR (BOL) in Vientiane in February 2000. Those discussions included staff from most Ministries and major Lao institutions and staff from the International Financial Institutions (IFIs). The official comments were presented by BOL to IFIs in October 2000. Second, a “High Level Policy Workshop” took place February 2001 to disseminate the main findings and engage policy makers. Third, further technical discussions took place in late 2001 and early 2002.

This final version is a joint effort and represents a consensus among the parties involved. The ultimate objective of the Financial Sector Note is to support the Government’s efforts in enhancing the financial sector’s ability to support economic growth thereby reducing poverty in Lao PDR.

In order to achieve this goal, Chapter I emphasizes the importance of the financial system for economic growth and stability in general, and, in particular, in the case of Lao PDR. Chapter II provides an institutional analysis describing the rules and incentives currently prevailing in Lao PDR. Chapter III describes the financial system which emerged in such an environment. Chapter IV assesses how successful the Lao financial system is, in performing its main functions and describes its current health. Chapter V focuses on the agricultural sector and at the non-agricultural private sector, and how they are financed.

This document has benefited from comments by staff of the Government of Lao PDR, the International Monetary Fund, as well as from peer reviewers from the Asian Development Bank and the World Bank Group. The team thanks them for their valuable insights. Obviously, all mistakes, errors and omissions remain ours.
INTRODUCTION

During the second half of the 1980s, Lao PRD embarked on an ambitious program of economic reforms, called the New Economic Mechanism, whose main purpose was to gradually transform its centrally-planned economy into a market-oriented economy. The initial reform momentum lasted about one decade.

The far-reaching reform program encompassed many critical components including: (a) promotion of private production through improved incentives; (b) institutional infrastructure to improve market economy operations; (c) the strengthening of Lao competitive advantages through trade liberalization and further specialization; and (d) the establishment of price stability through macroeconomic policy measures.

The systemic changes introduced in Lao PDR have contributed to a significant transformation of the country’s economic system, away from a rigorously centrally-planned economy and towards a form of market economy based on private ownership. The percentage of poor declined based on the national poverty line from 45 to 39 percent between 1992/93 and 1997/98. But the percentage of very poor did not decline and remained at slightly above 30 percent evidencing the need for even broader and faster growth.

Moreover, several factors slowed down the economic liberalization process. Such factors included the lack of transparency in government-business relations, a weak civil society, the position of some interest groups at the national and provincial levels, and the existence of non-competitive economic structures with a few firms and actors accounting for a large share of domestic production (except in agriculture).

In some areas, reform policy stagnated and is lagging. This is the case in the financial sector. The creation of a two-tier banking system in the early 1990s with separate and well-defined functions for the central bank and the state-owned commercial banks, has not resulted in the expected benefits: Lao PDR is still suffering from chronic macroeconomic instability and the state-owned commercial banks are suffering from a large amount of non-performing loans.

Taking into consideration the objective of the Lao leaders to improve the well being of the Lao People, this paper argues that there are valid reasons for establishing rules that discipline the political influence on the design and conduct of economic policy, and more specifically, policy regulating the financial sector.

---

1Agriculture has been reversed to the private household system. Many state-owned enterprises have been privatized (or liquidated). Factor markets have been liberalized and foreign direct investments promoted. Restrictions on internal trade have been removed. Business legislation has been modernized and a new constitution adopted. The role of the State in the economy has been redefined and made more limited. A market-adapted tax system has been introduced. Quantitative restrictions on foreign trade have been removed and replaced by lower import tariffs and export taxes on timber and other natural resources.

EXECUTIVE SUMMARY

Empirical evidence shows that financial system and economic growth—thus development—are significantly correlated. Based on this relation, we show that, in Lao PDR, the current shallowness of the financial system acts as a constraint to growth. A 4 percent per capita GDP growth (which would only raise Lao per capita GDP to US$895 in 22 years, i.e., a graduation from the least developed countries) requires that M2/GDP stands at around 50 percent compared to an average of 13 percent. This illustrates the size of the challenge.

Furthermore, the low financial depth of the financial sector can contribute to macroeconomic instability: monetary discipline is difficult to enforce as relatively small fiscal deficits will generate large monetary and inflationary pressures. This vulnerability was evidenced by investments financed in 1997 by the central bank to the tune of about 5 percent of GDP, which created high inflationary pressures resulting in much slower growth in 1998. Hopefully, recent macroeconomic policies if they are sustained will support the establishment of a stable macroeconomic environment. But the situation remains fragile.

The present institutional arrangements for the banking and financial sector in Lao PDR, i.e., the Ministry of Finance, the Bank of Lao PDR and the legal system could have contributed much more to fostering financial sector stability and promoting efficiency and development.

The Ministry of Finance could have contributed more with its budget deficit financing program, and by unambiguously allowing adequate tax deduction for provisions and losses. The Ministry of Finance is also responsible for accounting laws, regulations and procedures and establishment of financial disclosure requirements. An adequate accounting framework is an essential element of the infrastructure without which no financial sector development can take place. Since January 1997, a new chart of accounts was introduced to modernize Lao bank accounting and bring it closer to IAS standards. But enforcement and compliance has lagged.

The Bank of Lao could have contributed more to financial sector development if it had a clearer mandate, as the institution’s mandate reveals potentially conflicting objectives. Monetary policy cannot be very effective when (a) the economy is 80 percent dollarized, i.e., Kip account for only 20 percent of currency in circulation; (b) insufficient autonomy vis-a-vis the executive power translates into long policy making process as BOL consults and seeks approvals; (c) policy or directed lending is a significant share of overall lending; and (d) BOL’s financial resources are limited. In addition, the Bank of Lao is a young institution and its bank supervision function is still weak especially in the enforcement area. Finally, the lessons of the 1994 recapitalization remain to be articulated including the collection of non-performing loans.

Despite the fact that there are some gaps and inconsistencies in the laws, the Lao Constitution is very supportive and the laws are somewhat supportive of the banking and financial sector. But narrow and restricted dissemination of legislative acts and regulations is responsible in part for the lack of compliance and uncertain outcomes when rights are to be protected. Existing laws are not always forcefully and systematically applied and judgments enforced, as the judiciary function remains too weak.

---

3 The word “dollarized” is used here to mean currencies other that Kip i.e. US dollar and Thai bath.
The Lao banking sector can be described as small in absolute terms, with total assets in the system amounting to approximately US$400 million. It is also relatively small when compared to the size of Lao economy: the ratio of total assets of the banking system to GDP is about one-fourth. This is particularly low for an economy with a non-diversified financial system (i.e., with no alternative but banks for the supply of loans) and it evidences a system in its early stage of development. The loan-to-deposit ratio stood at a low 50 percent. Three quarters of loans were in foreign currencies and share of loans to the private sector stood at 50 percent.

State-owned commercial banks dominate the market with more than two-thirds of the total assets. The three largest banks (BCEL bank, Lao May bank, Lane Xang bank) are fully owned by the government; BCEL maintains a dominant position accounting for approximately half of total deposits, and almost 40 percent of total loans in the system.

There are only few non-bank financial institutions (NBFI) in Lao PDR, evidencing a narrow, i.e., undiversified financial system where there is still limited alternative to banks for access to financial services. The microfinance system is starting to emerge; there is only one insurance company; and the Social Security system is still in its infancy with little or no accumulated financial surpluses.

Thus, this banking and financial system, dominated by public banks, is unable to perform most expected functions which are to (a) mobilize savings; (b) research and allocate capital; (c) exert corporate control; (d) facilitate trading of goods, services and financial contracts; and (e) facilitate trading, hedging and pooling of risks.

The banking system in Lao PDR is in a difficult situation. Four major institutions, holding two-thirds of the banking assets and almost 80 percent of total deposits, are insolvent: NPLs account for 60 percent of loans on average. There appears to be three main reasons: lack of capacity in banks, price distortions as interest rates are unambiguously guided and policy/directed lending mostly to loss-making enterprises many state-owned. In that respect, the financial situation of banks and SOEs are highly interdependent. The Lao banking system needs at least US$50 million of capital but also good borrowers. In the case of a small and concentrated economy such as Lao PDR, the capital adequacy ratio should be at least 12 percent to ensure that the banking system would not be wiped out after the first economic down turn.

The financial sector does not serve very well the agricultural sector which accounts for over 50 percent of GDP and employs over 85 percent of the population. The supply of financial services has remained very low. In some cases there are special arrangements, otherwise besides the Agricultural Promotion Bank and informal lenders, there are little choices as there are only a few recent microfinance projects established with the objective of becoming sustainable.

Similarly, the financial sector does not serve very well the private sector which, despite its current small size, could become the future engine of growth and therefore development. To underpin that growth, the Government’s role in providing public goods—such as the market infrastructure including a supportive financial system—is essential. Furthermore, this is entirely consistent with the Government strategic decision to decentralize, seeking to improve efficiency in the development process by allowing decisions to be made closer to the site of action and by the people who stand to gain or lose the most.
CHAPTER I. MACROECONOMIC ISSUES

1. Chapter I provides an empirical evidence that financial system and economic growth—thus development—are significantly correlated. Based on this relation, we show that, in Lao PDR, the current shallowness of the financial system would act as a constraint to growth. Furthermore, the low financial depth of the financial sector can contribute to macroeconomic instability if macroeconomic management is not adequate.

A. FINANCIAL SYSTEMS AND GROWTH

1. Some Cross-Country Evidence

2. A healthy financial system is essential to sustainable economic development. In order to support economic growth, the financial system should be effective at: mobilizing domestic savings; facilitating trading of goods, services and financial contracts; providing an efficient trading, hedging and pooling of risks; allocating capital; and, exerting corporate control. Moreover, the system should offer a variety of financial services adapted to diversified economic agents. And it should, as needed, be effective at attracting foreign capital for the financing of productive investments—by complementing rather than substituting for domestic sources of financing.

3. In many developing countries, most financial systems fall short of the above “ideal” features: financial systems tend to be shallow, and the financial intermediation process costly as well as lacking efficiency, transparency and stability. The number of countries experiencing significant banking problems has increased substantially in the past decade, with many of these countries witnessing major, costly financial crises.

4. Beyond the short-term effects suffered by those economies, these shortcomings have longer-term consequences for rates of growth achieved. Indeed, evidence worldwide points not only to the existence of a strong, positive link between financial development and economic growth, but also to the fact that the level of financial development in a given country is a good predictor of future economic development. Cross-country relationships between economic growth and aggregate measures of financial sector performance show, in particular, that:

- financial sector depth (as measured by the ratio of financial assets to GDP) is strongly correlated to real per capita GDP;
- the share of credit provided by commercial banks (measured by the ratio of commercial bank credit to the sum of bank credit and central bank domestic assets) is closely correlated to real income, suggesting that banks are more likely to efficiently allocate credit for productive uses than the central bank through centrally-directed credit programs; and

---

the share of credit allocated to the private sector (measured by the ratio of credit allocated
to private enterprises to total domestic credit, excluding credit to banks), as well as the
ratio of credit to the private sector to GDP, are both correlated in a statistically significant
way to per capita GDP.

5. These findings support the existence of a strong positive relationship between the various
indicators of financial development and key growth indicators. Deepened financial systems and
an efficient allocation of resources by financial intermediaries lead to accelerated rates of growth
of real per capita income, as well as to faster capital accumulation and productivity growth.
Moreover, financial sector development does not merely reflect higher levels of economic
activity, but it also helps promote economic performance, indicating that “the initial level of
financial development is a good predictor of subsequent rates of economic growth, physical
capital accumulation, and economic efficiency improvements over the next thirty years, even
after controlling for income, education, political stability, and measures of monetary, trade, and
fiscal policy.”

6. When evaluating the effect of financial intermediation on economic growth, one should
consider it in a broad sense, including capital markets transactions in the definition. Indeed,
evidence shows that liquidity provided by stock markets, whether measured by the value of
shares traded on a country’s stock exchange as a percentage of GDP or by the stock market’s
turnover ratio, is a statistically significant predictor of economic growth, capital accumulation,
and productivity growth over the longer term.

7. In the Asian context, poorly developed financial systems will thus retard economic
growth, and they can do so just as powerfully as other factors such as the existence of large
government deficits, the persistence of large parallel market exchange rate premia, poor
infrastructure, weak protection of property rights, the existence of an inefficient bureaucracy, or
low rates of school attendance.

2. Lao PDR’ Growth Objectives: Implications for the Financial System

8. Lao set for itself ambitious growth objectives, with projected growth rates of 6 to 7
percent per annum over the medium term. The achievement of such objectives would have
important implications for the financial system. Using Easterly-Levine’s growth regression
model as applied to the above cross-country sample over the 1960s, 1970s and 1980s, the
following question was investigated: which would be (ceteris paribus) the required level of
financial depth (M2/GDP) necessary for Laos to achieve a sustained rate of growth of real
per capita GDP of 4 percent (which, given present population growth, would be equivalent to a
6 to 7 percent annual GDP growth rate)?

---

3Turnover ratio: value of shares traded relative to value of shares listed on the stock exchange.
4See its effects measured over eighteen years for a sample of 49 countries analyzed over the period 1976-93: Levine,
December 1996.
9. Although the data have to be interpreted with caution, the results point to a need to an increase of Lao’s M2/GDP ratio to about 50 percent, from the low average 13 percent achieved in the past years (see Figure 1). This illustrates that the financial sector will act as a heavy constraint if not dealt with in a decisive manner. To be noted that M2 as defined here, is the result of a demand for the real money stock linked to economic activity and cannot be set by a simple decision to supply the targeted amount. Also, the level of M2/GDP depends on the structure of the financial system; it needs to be compared with countries where the financial system is dominated by banks as opposed to capital markets.

![Figure 1. Financial Deepening (M2/GDP, %)](image1)

**Figure 1.**

*Financial Deepening (M2/GDP, %)*

![Figure 2. Composition of Broad Money, Lao PDR (Oct-1999)](image2)

**Figure 2.**

*Composition of Broad Money, Lao PDR (Oct-1999)*

*Note:* As can be also seen from Figure 2, foreign currencies are widely used in the Lao economy. We use an M2 measure that includes foreign currencies because those currencies are effectively used for economic transactions.

10. Moreover, as can be seen from Table 1, M2/GDP is among the lowest in the world in Lao PDR. Former planned economies (*) tend to have lower financial depth.

![Table 1. Financial Depth: Country Comparison (1997)](table1)

<table>
<thead>
<tr>
<th>Country</th>
<th>M2/GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lao PDR (*)</td>
<td>18</td>
</tr>
<tr>
<td>Vietnam (*)</td>
<td>24</td>
</tr>
<tr>
<td>Thailand</td>
<td>90</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>38</td>
</tr>
<tr>
<td>Burkina Faso (*)</td>
<td>25</td>
</tr>
</tbody>
</table>

We use Easterly-Levine’s “best” regressions (Table IV) in which the regression coefficient for the “financial depth” (M2/GDP) variables is 0.011. Assuming a “target” rate of growth of per capita real GDP of 4 percent we end up with the following factors augmenting the “observed” average (M2/GDP) ratio for Laos in the 90s (13 percent):

<table>
<thead>
<tr>
<th>Estimated (M2/GDP) coefficient</th>
<th>4% Growth in real per capita GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.011</td>
<td>0.011 x 3.63 x 0.13 = 0.473</td>
</tr>
</tbody>
</table>

In other words, ceteris paribus, to achieve in the 1990s a 4 percent rate of real per capita GDP growth would have required an (M2/GDP) ratio 3.6 times higher than the average observed (M2/GDP) ratio. That is, instead of an (M2/GDP) = 13 percent it would have been required to reach ratios of almost 50 percent. If real per capita GDP growth is to reach 4 percent, then the “required” (M2/GDP) ratio should be as high as 50 percent. The same ratio would be required going forward.
11. The objective of raising M2/GDP to 50 percent appears ambitious in terms of the financial sector and consistent with the Government’s objective\(^7\): a four percent per capita GDP growth would raise Lao per capita GDP to US$895 in 22 years, i.e., IBRD eligibility. Hence, Lao PDR would graduate from the least developed countries around 2022. Lao PDR’s future GDP per capita would still remain below today’s average GDP per capita in East Asia and Pacific (US$990). But this future result should presently be considered optimistic in Lao PDR as the country is facing additional challenges.

**B. FINANCIAL SYSTEMS AND MACROECONOMIC STABILITY**

12. A shallow financial system which makes limited or little contributions to growth is not the only problem facing Lao PDR. A shallow financial system actually also feeds into macroeconomic instability because the economy is vulnerable to small monetary shocks as recent history has shown. Improvements in the financial sector will also have the effect of improving macroeconomic management.

13. The lack of financial depth makes monetary discipline difficult to enforce as relatively small fiscal deficits will generate large monetary and inflationary pressures. For example, this vulnerability was evidenced by off-budget investments financed in 1997 by the BOL to the tune of about 5 percent of GDP. This resulted in a monetary expansion of almost 100 percent at this level of financial depth. These policy actions accelerated the depreciation of the kip, and quickly fed into higher prices in an undermonetized and dollarized economy (See Figures 3 and 4).

14. In the case of Lao PDR, the financial sector and the macroeconomy are struggling in a circle. Confidence in the financial sector and in the currency has been undermined by some policies resulting in a low savings rate and a shallow system. In turn, this shallowness and other inefficiencies (as we will see later) are contributing to macroeconomic instability.

15. A high level of inflation is detrimental to the economy. A stable and balanced economic environment, with low inflation, is a necessary condition for financial sector development and

---

\(^7\) The Lao PDR’s over-arching development goal is to graduate from the Group of Least Developed Countries by the year 2020 through sustainable and equitable development. This objective has been defined by the 6th Party Congress in 1996.
efficient intermediation, which in turn can accelerate economic growth. Indeed, inflation influences economic growth primarily through affecting financial sector development.

C. IMPORTANCE OF MACROECONOMIC MANAGEMENT

16. In such an environment, adequate macroeconomic management is crucial to ensure confidence and stability as recent history has demonstrated. While the East Asian financial crisis provided a shock, weak economic management contributed to lower confidence and lower resources available for investments in the Lao economy. But recent stabilization measures are becoming effective.

1. Less resources were available

17. Investments are critical to economic growth and thus deserve special attention as it determines to a large extent the future health of an economy. It lays the basis for future production. But investments need to be financed with adequate resources such as domestic savings, foreign direct investments (FDI) or international aid.

18. While national accounts statistics are not always completely reliable, estimates of domestic savings indicate that they are still relatively very low in the Lao PDR in contrast with other (more developed) East Asian economies where rates are between 30 and 40 percent of GDP. Using available data, it appears that the national saving rate has remained stagnant over the last five years, averaging less than 13 percent of GDP and has fallen to about 8.7 percent in 1998.8 Since domestic savings are not sufficient to cover all investment needs, Lao PDR has to rely on foreign direct investments and aide.

19. To some extent, spooked by the high inflation rates9 foreign investors scaled down their projects and FDI declined: foreign private investments have dwindled from high levels of USD hundreds of million in the early 1990s to about 45 million in 1998. Foreign investment disbursements fell from $104 million in 1997 to about $60 million a year in 1998 and 1999, and a further decline is expected. This decline is largely due to delayed hydropower investments as a result of the economic crisis in Thailand, a major investor in the sector in the Lao PDR.

20. Disappointed by the results of some inadequate policies, donors reduced aid as the donor community tends to focus more on results and on measuring the impact of reforms in the context of dwindling aid resources. (See Figure 5).

---

8 It is to be noted that Lao statistical capacity is weak and it is possible that savings rates are underestimated due to considerable unrecorded trade. Furthermore, savings which are not in a monetary form would not be captured. In a high inflation environment, it is conceivable that savings are kept in kind (rice, seeds, gold, precious stones...) rather than in kip when people cannot access other currencies as substitutes for stable stores of value.

9 The kip precipitously fell in value against the dollar (from below 1000 kip/US$ before the crisis to about 9500 kip/US$ in July 1999) and inflation accelerated to triple-digit levels, reaching as high as 170 percent on a year-on-year basis at its height (March 1999/March 1998).
2. But Public Investments Remained at a High Level

21. Up to a few years ago, the Government had been managing to balance the recurrent budget for most of the recent years, and while the overall fiscal deficits (including capital expenditures) as a ratio of GDP were large, they were mostly financed by aid resources (mostly grants and some loans) and without recourse to the central bank. However, there was an increasing trend in the overall ratio. (See Figure 6).

22. Unfortunately, in this context of declining resources, the Government, did not pursue policies to increase its own revenues—for instance by not adjusting the exchange rate used for custom valuation hence foregoing revenues in the range of 2 percent of GDP—and was therefore forced into central bank financing with the consequences on inflation and the Kip mentioned earlier.

3. With Lower Investment Efficiency

23. As private investments declined from almost 20 percent in 1996 to about 10 percent in 1998, public investments as a percentage of GDP increased from 10 percent in 1994 to 12.6 percent in 1998. But as public investment share increased, the efficiency of investments declined.
24. The Incremental Capital Output Ratio (ICOR)\textsuperscript{10} measures investment efficiency. A rising ICOR is interpreted as indicating a declining output response to investment and thus a falling efficiency of investment. In almost all the crisis countries ICORs increased in the 1990s.\textsuperscript{11} In the Lao PDR, ICOR continued its upward trend during the last 5 years (see Figure 7), suggesting that investment became less efficient in generating growth. However, it is to be kept in mind that ICORs measures are based on quite unreliable national accounts statistics and the interpretations are indicative only.

25. The recent public investments do not appear to yield expected returns evidencing the limits on what public sector investments have achieved to spur economic growth. These results should at least trigger a discussion about what should be the nature and level of public investments in Lao PDR.

![Figure 7. Investment and ICOR (Lao PDR)](image)

26. Consequently, GDP growth in 1998 slowed to 4 percent. (See Figure 8). The current situation was not sustainable: the country needs a stable macroeconomic environment to promote social peace and on a more rapid growth path to significantly reduce poverty.

![Figure 8. GDP Real Growth](image)

\textsuperscript{10}ICOR = investment/increase in real output = (ratio of investment to GDP)/(GDP growth rate). This is the reciprocal of the investment efficiency ratio = increase in GDP/investment.

\textsuperscript{11}In Korea and Thailand, ICORs approximately doubled between 1990 and 1995. Source: IMF World Economic Outlook, October 1998.
4. Recent Stability Measures.

27. Hopefully, recent macroeconomic policies if they are sustained and implemented consistently will support the establishment of a climate of confidence necessary to mobilize domestic savings and attract foreign investors and donors to Lao PDR again.

28. Initially, the authorities started to implement stabilization measures from late 1998. These included the sale of treasury bills to absorb excess liquidity, tax measures and expenditure restraints. But these measures were not implemented consistently, and lead to extreme volatility in exchange rates and prices.

29. However, since mid-1999, GOL reduced the fiscal deficit within 8% of GDP for 1999-2000 and further committed to reduce it while avoiding advances from the central bank. In addition, in September 1999, with the increased and sustained use of central bank bills and treasury bills, GOL succeeded in contracting the inflation to less than 100% for the first time since April 1998. Furthermore GOL introduced high-interest certificates of deposits in October 1999. As a result in June 2000, inflation only increased at a rate of approximately 10% per annum. (See Figure 9). Consequently, GDP growth resumed at a higher pace, consistent with the country’s long term poverty reduction objectives. (See Figure 10).

30. The current situation is fragile as the financial system remains shallow and the underlying structural weaknesses are not yet addressed: the macroeconomic stability depends too much on monetary policy as opposed to depending on a mix of adequate fiscal, trade and monetary policies.
CHAPTER II. INSTITUTIONAL ANALYSIS

31. In Chapter I we saw that financial sector development is essential to promote economic growth. Obviously, the financial sector does not develop in times of crisis. Therefore institutional arrangements and policies should be aimed first at avoiding crisis in the financial sector. Then, institutional arrangements and policies should be aimed at improving the efficiency of the financial system.

32. Chapter II contributes to answering the question whether the present institutional arrangements in Lao PDR foster financial sector stability, promote efficiency and development. This Chapter describes and analyzes the institutional framework for the Lao financial system. After an historical perspective, we analyze how the Ministry of Finance and the Central Bank perform their respective various functions. We also analyze the general legal framework and judicial enforcement in Lao PDR.

A. AN HISTORICAL PERSPECTIVE

33. Since the New Economic Mechanism (NEM) was initiated in 1988, the development of the Lao financial sector can be divided into three periods. During the first period (1988-1991), the mono-banking system instituted in the State Bank of Lao (SBL) since 1975, was replaced by a two-tier banking system (March 1988). The commercial banking activities of the SBL were separated from central banking function and three of its branches were spun off as independent banks. In 1990, the Central Bank Law (Law No. 4) established Bank of Lao PDR (BOL) as the central bank, in place of SBL. Four more state-owned commercial banks (SOCBs) were created during 1990-1991. All seven SOCBs were under the management control of BOL and each was assigned a geographical area of coverage. A first joint venture bank with 30 percent Government equity was also established. The legal and prudential frameworks were inadequate, bank supervision and commercial banking experience scarce, resulting in low performance and increasing non-performing loans (NPLs).

34. The second period (1992-1995) witnessed an increase in the number of financial institutions in Lao PDR. The Prime Minister Decree no. 3 of 1992 on the Management of Commercial Banks and Other Financial Institutions, which defined banking business and the requirements for the establishment and operations of commercial banks, paved the way for the establishment of the private banks. Six branches of Thai banks, a branch of a Malaysian bank, and a second joint venture bank were established. In 1993, the Agriculture Promotion Bank was created by Prime Minister Decree to act as the country’s agricultural development bank. A number of foreign exchange bureaus, mostly owned by the commercial banks and some by individuals, were opened. Despite improvements brought to the legal and prudential framework the financial health of the system did not improve due to weak enforcement: non-performing loans of SOCBs accounted for over 35 percent of their outstanding loan portfolios in 1994. To meet capital adequacy requirements, the Government proceeded with a first round of recapitalization of the SOCBs. In 1995, the Law on Bank of Lao PDR improved on the 1990 Central Bank Law.
35. During the third period (1996-to date) improvements were made to banks’ legal and regulatory framework. Six prudential regulations for commercial banks and APB were also issued by BOL in 1996, and a new regulation on asset classification and loss provisions was promulgated in 1998. A new chart of accounts was also introduced for the commercial banks in 1996. In 1997, the Decree Law on Management of Commercial Banks and Other Financial Institutions replaced the Decree no. 3 of 1992, making the board of directors the policy making body of each SOCB and vesting in the Ministry of Finance (MOF) the power to appoint the chairman and other members of the board. Recently, in 1999, the Law on Bank of Lao PDR was amended; one amendment consisted in removing the power of BOL to appoint key executives of SOCBs. The continuing SOCBs’ poor performance was revealed by audits on 1996 and 1997 accounts of the SOCBs. In 1998, Government launched a program to consolidate, corporatize and recapitalize the SOCBs. Recapitalization has yet to take place and more important a plan developed to ensure long term sustainability of those resulting institutions including adequate institutional arrangements and incentive framework. Despite improvements in the framework, implementation and enforcement has remained weak throughout the second and third period.

B. THE MINISTRY OF FINANCE

36. The Ministry of Finance\textsuperscript{12} (MOF) is an important institution of the financial system. First, the MOF dominates policy making and decisions related to the financial sector. Second, depending on how it finances its needs, the MOF can contribute or retard the development of the financial sector. Thirdly, the MOF is in charge of the accounting framework, an essential element reducing information asymmetry.

37. MOF could have contributed more to the development of the financial sector with its budget deficit financing program, by clearly and unambiguously allowing tax deduction for provisions for bad debts and by imposing disclosure requirements.

1. Responsibility for the Financial Sector

38. MOF’s main responsibility is the formulation and implementation of fiscal policies. MOF is responsible for the preparation of the government budget to be submitted to the National Assembly and to administer the approved budget, including inspection of state-owned enterprises and government ministries for compliance. MOF is in charge of (a) tax administration; (b) customs duties; (c) managing the investments of the government in state-owned enterprises, including SOCBs since recently when ownership was transferred from BOL to MOF; (d) management of state property; and (e) government procurement guidelines and regulations.

39. MOF has a key role in foreign borrowings, which involves coordination with the Committee for International Cooperation and Investment and the Committee for Planning and Cooperation. MOF is responsible for servicing the external and domestic debt obligations of the

\textsuperscript{12} According to the Decree 127/PM dated Oct. 3 2000, “The Ministry of Finance, is a public administrative organization within the Government’s machinery having the role of ensuring the management of public finance, accounting, government budget and asset and land areas for the whole country in a uniform manner, in line with the Party-Government policy/guidelines to serve the tasks of protection and socio-economic development of the country, ensuring its stability and strength in line with the Renovation Policy.”
Government has also an important role in economic reforms. In these matters, MOF coordinates with BOL.

40. For example, the recent policy statement confirming the merger plan for the SOCBs dated May 15 1998, was issued jointly by the Finance Minister and BOL Governor. This policy statement was widely regarded as the official authority to proceed with the process of restructuring the SOCBs. With the merger and corporatization of these banks, the MOF became the sole shareholder and the authority for appointment of members of the boards of the state-owned banks. The recent amendments to the Bank of Lao Law and the Decree Law on Commercial Banks and Other Financial Institutions also transferred the authority to appoint the managing director of the SOCBs to MOF. The underlying problems have yet to be articulated clearly and addressed.

2. Financing the Budget Deficits

41. In deciding to finance its needs with Treasury-bills (T-bills) the MOF is contributing to developing the financial sector as it makes available relatively liquid financial instruments which serves as benchmarks. The Budget Department is in charge of designing the need and volume of T-bills to issue and make a recommendation to the government. The Treasury Department would be in charge of actual issuance. BOL acts as a manager of T-bills and other government security issues. T-bills are sold at a discount in certificate form in units of Kip 10 million. Maturity of T-bills is usually 6 months. Until March 1994, Government securities were not non-transferable and sold in limited volume directly to individuals. Starting in March 1994, T-bills were auctioned under a tendering mechanism.

42. T-bills were auctioned by BOL twice a month. To facilitate trading, BOL opened a discount window for T-bills in May 1994. Only limited secondary trading actually took place and the market remained quite thin. The rate at auctions was used as reference for determining lending rates of commercial banks. However, from October 1997, yields on T-bills were capped at 20 percent per annum, as the Government sought to lighten the interest burden on the fiscal budget arising from deficit financing. As real interest rates became increasingly negative in the face of accelerating inflation, participation of commercial banks in the biweekly auctions of T-bills declined. In April 1998, the auctions were stopped because of lack of bids from the commercial banks. From April to end of 1998, 6-month T-bills were sold at a fixed rate of 24 percent. In January 1999, the rate on T-bills issued (Kip 55 billion lot) was increased to 30 percent. Initially, those T-bills did not sell easily as more than half of this lot remained unsold for a few months.

3. The Accounting Framework

43. An adequate accounting framework is an essential element of the infrastructure without which no financial sector development can take place. The reasons are many. Accounting provides the necessary information to the financial institutions hence solving, in part, the informational asymmetry problem. Accounting also facilitates management of banks and companies, promotes good governance as results can be measured and hence accounting improves the performance of the economy. MOF is also responsible for accounting laws,
regulations and procedures and other financial legislation and regulations as well as training and examining accountants for registration to practice as accountants and auditors.

44. In Lao PDR, it appears that a basic accounting framework is in place although improvements can be made. Implementation of that framework, including auditing requirements and disclosure remain weak at best. There are 15 accounting and auditing firms established or in the process of requesting a license.

**Enterprise Accounting**

45. All companies, including state-owned companies (SOEs) are required to produce financial statements, including the balance sheets, profit and loss statements, sources and uses of funds, tax returns, and depreciation schedules for fixed assets. Three different levels of accounting methods and reporting requirements (basic, extended, and advanced) are applied to companies depending on their size. The implementing decree generally conforms to the International Accounting Standards (IAS). However, the chart of accounts is standardized for all industries and for example, a hotel business is to follow the same chart as a manufacturing company even though requirements are different.

46. The chart of accounts has been published in Lao, English and French and detailed guidelines on following the chart of accounts have been published in Lao. The structure of the chart of accounts is quite detailed and guidelines are rigid on presentation leading to the concern that form may take precedence over substance. Accounting is used essentially for computation of tax returns, but not yet to measure performance, monitor risks, and business planning.

**Bank Accounting**

47. Since January 1997, following the promulgation of the Decree on Accounting for Commercial Banks No 03/PM in 1996, a new chart of accounts was introduced by the Bank of Lao to modernize Lao bank accounting and bring it closer to IAS standards. The chart of accounts is designed to cater to present and future needs; but it lacks some detailed specifications. As a result it is not implemented consistently across banks and even within each bank. This has resulted in delays in closing 1997 and 1998 accounts especially among SOCBs. In particular, difficulties arose in recording accrued interest on loan accounts, making provisions for bad and doubtful debts, and recording and reporting of contingent liabilities and off-balance sheet items.

48. There are bank specific issues. First, BOL Regulation No. 98 established a “General Loan Loss Reserve.” But its current level set at 0.5 percent of total amount of loans outstanding (only that amount is tax-deductible) may appear too low for an economy where risk tend to be concentrated such as Lao PDR. Second, the concept of non-accrual status for non-performing assets is only being implemented recently, thus banks have overestimated their taxable earnings.

---

13The Enterprise Accounting Law which was issued by Presidential Decree in 1990 sets out the accounting requirements to be followed by all private enterprises, state-owned enterprises and joint venture undertakings in which the Government is a shareholder. The law applies to state-owned and private commercial banks. The basic implementing guidelines on accounting are stipulated in the 1992 Decree on Implementation of the Enterprise Accounting Law.
Specific provisions are not unambiguously tax deductible as they should be considered a normal cost of business (BOL Regulation No. 7). Finally, foreign exchange (FX) gains and losses on long term assets and liabilities must be amortized over the life of the underlying asset and liability which is contrary to the mark to market international practice. FX losses was widespread when the kip depreciated substantially.

**Auditing**

49. All public and private enterprises with a capital in excess of 100 million Kip are legally required to have their accounts audited. However, this cannot be enforced in practice because of acute shortage of qualified certified public accountants (CPAs) in Lao PDR. Formal education for accountancy in local schools is limited to basic bookkeeping and theoretical concepts of accounting, with little or no practical application. The Accountancy Board conducts a 6-month training program as a requirement for registration of government and private auditors. Lao staffs of international accounting and auditing firms are sent to overseas branches for further training.

50. Commercial banks are required to conduct a yearly external audit. However, SOCBs have not complied strictly with Article 64 of the Decree Law on Commercial Banks dated March 22, 2000.

**Disclosure**

51. Article 46 of the Decree Law on Commercial banks specifies that commercial banks and financial institutions are required to publish their accounts at the end of each financial year. Some foreign branches provide financial figures on the Lao branch operations extracted from the audited accounts or annual reports. There is no such requirement for the SOCBs which are treated differently under the Decree Law although they have occasionally published their financial statements albeit with significant delays.

52. Few private local business enterprises make their annual reports publicly available. Generally, the value of disclosure is not understood and appreciated by the Lao private sector. The exceptions are the subsidiaries of foreign companies, which follow the practices of the parent company and apply the standards of the country of the parent company.

53. By law, all companies are required, to submit their financial statements, along with the tax returns, to the Tax Department of MOF. This requirement applies to banks. In addition, banks are also required to submit financial statements to BOL.

**Government Accounting and Auditing**

54. The Government accounting system has not been able to cope with the increasing demand for correct recording, classification, analysis and reporting of financial transactions. In all ministries there appears to be internal audit or inspection departments. However, the role and functions of these departments are not clearly defined and as a result they do not appear very active. External audit services have limited effectiveness when transactions become unauditable because of lack of accounting procedures and controls. This is, in part, why the recently established National Audit Office cannot be fully effective yet. However, the Prime Minister’s Office is aware and some of the above issues are currently being addressed.
C. THE CENTRAL BANK

55. The current institutional arrangements do not promote financial sector stability due to the Central Bank lack of autonomy. Domestic monetary policy cannot be effective in an 80 percent dollarized economy. Bank supervision remains weak, mainly in the enforcement area, one of the causes of financial crisis.

1. Insufficient autonomy

56. The Bank of Lao PDR Law establishes BOL in charge of usual central bank functions i.e. monetary policy, reserve management, bank supervision, lender of last resort and payment system. However, the institution’s mandate reveals conflicting objectives and a lack of autonomy vis-a-vis the executive power. This is a major weakness and handicap in times of instability and high inflation as experienced since 1997. For example, in 1999 average inflation rate stood at 134 percent. Statistically, there is a strong correlation between central bank’s autonomy and the level of inflation in one country (see Figure 11). BOL lacks autonomy for two reasons: its mandate and its governance structure.

![Figure 11. Central Bank Independence and Inflation (1960-92)](image)

**Mandate**

57. BOL’s mandate appears somewhat wide as the institution is expected not only to “promote and maintain internal and external monetary and efficient payment system mechanism and solvency of the banking sector…” but also “to promote and facilitate the flows of money to serve the plan for socioeconomic development of the Lao PDR.” (Article 3 of BOL Law). Only with a clear hierarchy of priorities, these two mandates will not result in conflicting objectives.

58. Furthermore, “BOL shall perform other tasks as provided by law or as assigned by the Government” which leaves the door open to almost anything, consistent with “…to serve the
plan...” (Articles 5 and 3). Acting under this mandate, BOL financed the “irrigation scheme”, upon the request of the Government. BOL acted as a development bank, lending to State-Owned Enterprises (SOEs) and the private sector covered by the scheme. Amounts lent were considerable, estimated by IMF at 5 percent of GDP as of June 1998.

59. BOL is authorized to grant temporary advances to the Government, but the law specifically limits advances to the Government at 25 percent of average annual ordinary revenue of the past three years. This limit is not observed whenever Government wants to overrule it by invoking the above provision and serves no use in imposing fiscal discipline. In that respect, the general trend observed in developed and developing economies is to clearly make price stability the number one priority of a central bank.15

**Governance Structure**

60. The BOL Law No.5 promulgated in October 1995 and amended in October 1999 establishes BOL’s governance structure. BOL is a financial institution of the Government with an equivalent status to a Ministry, reporting to the Government.

61. The highest authority of the BOL is the Board of Governors which consists of seven to nine members who are appointed and can be removed by the Prime Minister based on the proposal of the Governor of the BOL. The Deputy Prime Minister chairs the Board with the Governor and MOF as vice-chairmen. The members of the Board have terms of office for five years. Similarly, the “Governor shall be appointed or removed from office by the President of the country upon proposal of the Prime Minister, then proposed to the National Assembly for approval” (Articles 12 and 17). Finally, the Prime Minister appoints the Directors of BOL’s Departments (Article 19).

2. Inefficient Monetary Policy Management

62. Both direct and indirect instrument of monetary policy are available to BOL. BOL still has a strong influence on interest rates although the Government has proclaimed its intent to establish a market-responsive banking system as it moves towards market economy, and ceilings on commercial banks’ lending rates (except for agriculture) have been removed. This is demonstrated by the minimum deposit rate set by BOL, the cap placed on Treasury bill auctions and the fixing of interest rates on BOL bills and Government securities. The BOL Law gives BOL ample latitude to set interest rates. Article 39 was amended recently and specifies now that “the Bank of Lao PDR shall set and disseminate interest rates applicable on the purchase of discounted bonds and loan interest rates in advance among commercial banks and financial...

---

14 The final objectives are legitimate, but the question whether it is BOL’s role remains. In any case the paddy production in 1999 reached 2.1 million tons, making the country self-sufficient in rice and allowing for some exports.  
15 For instance, in the statutes of the new European Central Bank, the preservation of the value of the currency is specified as the primary goal of the central bank, with the promotion of full employment and growth as an objective to be pursued to the extent that it does not conflict with the goal of price stability.  
16 In 1996, BOL started issuing BOL bills as indirect instruments of monetary control and bank reserve management. The use of both instruments was discontinued in 1998 and resumed in 1999: In April 1999 BOL bills were issued at 60% interest rates and Certificate of Deposits by commercial banks in October 1999 with 60% interest rates (later 48%) with a matching facility of blocked deposits at the BOL.
institutions under its management. Such commercial banks and financial institutes shall be authorized to apply such deposit and loan interest rates towards their customers in accordance with the state adjusted market mechanism.” This version appears more liberal than the previous version.

63. There are four main reasons why monetary policy is not effective in Lao PDR. First, the economy is 80 percent dollarized\(^{17}\), i.e., only 20 percent of currency in circulation are Kip; second, the lack of autonomy translates into long policy making process as BOL consult and seek approval from MOF; third, policy lending; and fourth, BOL’s limited financial resources constrains it from conducting adequate monetary policies.

Dollarization

64. The Lao economy is \textit{de facto} a dollarized economy. As economic agents wanted stability and the Kip did not provide them with a stable store of value, they shifted their holdings in foreign currencies.\(^{18}\) For the Government of Lao PDR, this is now a challenge. The Government may want to consider \textit{either} to move towards a fully dollarized economy in order to have the benefit of immediate stability and reduced transaction costs \textit{or} to implement the policies that will bring back over time confidence in the Kip, and realize the benefit of independent monetary policy, lender of last resort and seignorage, arising from having its own currency. Dollarization is a difficult debate which this paper does not attempt to settle. However, in the present situation as the recent history has shown, it appears that Lao PDR gets the worst of both world: high inflation, no seignorage and no effective monetary policy. In any case, there are a range of options such as Currency Board, crawling peg etc…that need to be studied carefully. However, whatever option is chosen, monetary and fiscal discipline will be crucial for the success of the option chosen.

Policy Making Process

65. Another cause of inefficient implementation of the monetary policy in recent years is the lengthy and opaque decision making process. By law, all the key monetary policies and action plans have to be approved by the Government. This is time consuming as BOL must explain the objectives, mechanism and consequences of the policies and the measures to “all related parties” participating in the monetary policy making. As a result, by the time the final decisions are

---

\(^{17}\) The word “dollarized” is used here to mean currencies other that Kip i.e. US dollar and Thai bath.

\(^{18}\)\textit{Foreign Exchange Situation.} In September 1995, the Lao PDR formally adopted a managed floating exchange rate system. In practice, however, the BCEL, being the largest state-owned commercial bank and the dominant player in the foreign exchange market, has been setting the rate in consultation with the Monetary Authorities. Other banks and exchange bureaus generally use the BCEL rate as the base for to setting their own rates. There is also a parallel market. On average, the market rate of Kip/US$ was at a 7 percent premium over the bank rate in 1997 and 1998. From January to March 1999, the premium began to increase to 20, 34 and 46 percent evidencing a larger disconnect between the official and market rates at that time. Recently, BOL has managed the exchange rate flexibly, permitting banks’ exchange rate to adjust so that there is no more than a 2% margin with the parallel market rate. The Decree No. 53/PCM “Governing the Management of Foreign Exchange and Precious Metals” of 1991 regulates current and capital account transactions. In principle, current account settlements associated with external trade of goods and services are free of restrictions. In practice, however, due to shortage, foreign exchange is rationed. The allocation criteria include the level of necessity of imported goods and services. Foreign Direct Investments are the main foreign capital transactions as there is no stock exchange.
made, they tend to be outdated. Central Bank autonomy is important because at times preserving the value of the currency or keeping inflation under control may conflict with government priorities.

Policy Lending

66. Policy lending\(^{19}\) is a constraint to effective monetary policy. Mainly due to the relatively high fiscal deficit, the Government seeks “out-of-budget” resources to finance its investments or SOEs and calls on the commercial banks. This option is largely used by the Lao government and is another reason why BOL monetary policy cannot be very effective. When BOL uses interest rates (a market instrument) with the intent to limit credit availability to high return projects, policy lending interferes with normal market credit allocation and therefore reduces the efficiency of the policy decision. The more policy lending—and evidence suggests that approximately 50 percent of credit is directed—the less efficient the instrument. It also makes the control of aggregate credit very difficult for BOL as policy lending decisions are not always closely coordinated.

Financial Situation

67. BOL’s financial capacity may limit its effectiveness in implementing monetary policies. BOL’s profits are required to be remitted to the State budget, after due deduction of a contribution to a “business expansion fund” and the “general reserve account” to compensate for the losses incurred from the implementation of monetary policy. The build up of these reserves depends on the amount of contributions decided by the Board of Governors, in consultation with the Ministry of Finance. Being a young institution, BOL may not have sufficient reserves to implement a “vigorous” monetary policy that the current situation calls for. The lack of T-bills forces BOL to issue bonds to withdraw liquidity from the market, incurring the interest costs. Furthermore, BOL incurs losses when implementing a strategic plan or program for the Government. Due to fiscal constraints limiting its resources, MOF allows BOL to deduct those losses against profits without compensating BOL for those losses. This further reduces BOL’s financial capacity (Articles 8 and 9). Recently, BOL has decided to share its detailed balance sheet with multilateral donors.

3. Weak Banking Supervision

68. Despite recent improvements, banking supervision by BOL remains weak. The prudential framework which departs from international best practice in some aspects is not enforced. Consequently, BOL cannot contribute to financial stability as much as it should.

Legal and Prudential Framework

69. The requirements on capital adequacy and basic guidelines on operations of commercial banks were first set out in 1992. Since then, BOL has made progress in developing a legal and

\(^{19}\) Policy lending is defined here as including directed lending. See also IV C 1: Capital Allocation and Policy Lending.
prudential framework that is more suited to a market oriented system. The present framework can be further improved to come closer to international best practice (Basle 25 core principles). Indeed, the Decree Law only addresses the subject of the supervision in an elliptic way: it mainly addresses issues that are commonly embedded in Business Laws and has only a few articles that describe the main objectives pursued by supervisors and how they are to handle their duties. Although this kind of legal arrangement provides flexibility to supervisors, allowing them to take any action they deem necessary, it exposes supervisors to political pressure that may be difficult to resist and result in prudential forbearance and costly bail outs.

70 The Decree Law No. 2 distinguishes private commercial banks from state-owned commercial banks. Both types of institutions are subject to the same structural organization and operational aspects. But the role of their Board of Directors (BoD) differ in important aspects. In the case of SOCBs, the Minister of Finance appoints the Managing Director (MD), the deputy Managing Director and branch managers upon proposal of the BoD. This feature removes some autonomy and authority from the MD and therefore accountability for results. A branch manager, in particular, has less incentive to adopt a “corporate behavior” to protect the SOCB.

71. The lack of a specific *modus operandi* for treatment of failing and failed banks remains a weakness. Such procedures are presently needed. Some progress was achieved in the area of enforcement instruments. The Decree Law provides BOL with the right to fine and withdraw the banking licenses. BOL Regulation 4 (1996) adds the following tools to BOL supervisory toolkit: removal or dismissal of the Board of Directors and the temporary suspension or termination of activities. Annex 1 compares the current prudential regulation in Lao PDR with the Basle recommendation “25 core principles for effective banking supervision.” In any case, priority should be given to provisions strengthening governance and disclosure.

72. However, despite recent improvements in the framework and institution building efforts, effective enforcement of decisions is weak. Lack of people, necessary skills, resources, and procedures remain major constraints in banking supervision.

**Institutional Building**

73. The Supervision and Examination Department (SED) was established in 1998, when the supervision activities were spun off from the Control Department and three divisions were established under the new department: (i) off-site supervision, (ii) on-site examination and (iii) regulations and information. In 2000 the department had only 17 staff including ten supervisors who had only two or three years of supervising experience and little or no banking or auditing background. With only seven inspectors, it has not been able to field an on-site examination team every year in all 14 commercial banks presently operating in Lao PDR. The inspectors have not yet fully grasped the regulations and their proper application. They lack analytical skills to assess all the risks faced by banks and in particular credit risk: for instance, there were large discrepancies between BOL inspectors’ analysis of state-owned commercial banks’ loan portfolios and international banking consultants’ analysis. The off-site supervision division

---

20 Commercial banks are currently regulated by the Decree Law No. 2 dated March 22, 2000.
21 Decree Law signed by the President dated March 11, 1997.
22 SED became Bank and Financial Institutions Supervision Department (BFSD).
collects each commercial bank’s balance sheet, trial balance, income statement and financial ratios some everyday, some every month. This represents a huge amount of data as the emphasis seem to be on the quantity rather than on quality of information. Valuable information that indicate risk exposures, such as data on the ten largest borrowers, the foreign currency positions, lending to shareholders and SOEs are not obtained. Processing of raw data is largely limited to preparation of consolidated reports on all banks that are submitted to the Governor.

74. A Credit Information Bureau was created about two years ago. But it is not functional yet and BOL has to decide whether it will be housed with bank supervision or in the Accounting department.

75. The lack of follow up is also a cause of weak enforcement. BOL does not follow through and verify whether instructions are complied with by the banks. For example, BOL had issued Regulation No. 98 on May 15 1998 that specifies that interest on non-performing loans should not be accrued. It took almost two years to get compliance with this issued order.

76. Conflicts of interest have also been responsible for weak enforcement of decisions concerning SOCBs. Up to recently (October 1999) BOL had the authority to appoint the managing director and senior managers at the level of branch manager or higher, including the internal auditor of those banks. Most of the executives of the SOCBs came from BOL. Acting as the supervisory authority, BOL may be reluctant to take necessary actions against former BOL staff. As a result, the decision making process may be biased and the result sub-optimal. This illustrates the fact that an institutional set-up, in which the Government plays a leading role in all entities, is not conducive to effective enforcement of laws and regulations. Greater autonomy for each institutions, i.e., BOL and SOCBs would promote good governance.

**Deposit Insurance**

77. The BOL Decree Law on commercial banks requires all commercial banks to contribute, on annual basis, a percentage of total deposits of the previous year to a rehabilitation fund; but this was never implemented. After technical work, the Lao Authorities have decided to establish a Deposit Protection Fund on March 2000. A company wholly owned by the Government, with MOF as the sole shareholder, was formed and given a license on January 20, 2000 to manage the Fund. Participation in the fund would be compulsory for all licensed banks, but initially branches of foreign banks are not included in the insurance scheme. Contributions are paid twice a year based on average deposits during the immediately preceding six months. Only Kip deposits are currently be covered and the premium rate to be charged is 0.1 percent of average Kip deposits. Initial funding of Kip 100 million for the scheme has been provided by MOF. As of end of April 2001, seven banks had contributed a total of Kip 600 millions in premia which were invested roughly 60 percent in Agricultural Promotion Bank and 40 percent with BOL.

78. In theory, a deposit insurance scheme may contribute to the banking sector stability even though it is a controversial issue because of moral hazard. However, there seem to be a general agreement among experts that the sequencing of reforms in the financial sector is of great

---

23 With the passage by the National Assembly of the amendment of the BOL Law No.5 on October 20 1999, this authority has been transferred to the MOF.
24 BCEL, LaneXang, LaoMay, APB, JDB, VCB and LVB.
importance. This raises the question of the timing of such reform, i.e., establishing a deposit insurance scheme in the midst of an unresolved crisis. Based on evidence for 61 countries in 1980-97, a joint WB/IMF empirical study found that explicit deposit insurance tends to be detrimental to bank stability, the more so where bank interest rates are deregulated and the institutional environment is weak. Also, the adverse impact of deposit insurance on bank stability tends to be stronger the more extensive is the coverage offered to depositors, where the scheme is funded, and where it is run by the government rather than the private sector.

4. Handling Non-Performing Loans

79. The BOL contributed somehow to financial sector stability in its handling of non-performing loans after the 1994 restructuring of the SOCBs. BOL contributed to contain somehow the creation of a widespread loan default culture as recovery efforts were reasonable. No financial system can function when a non repayment culture is widely shared.

80. It is recalled that SOCBs’ non-performing loans amounted to approximately Kip 18 billion ($25.6 million), or 35 percent of total outstanding loans as of end of August 1993. Kip 14 billion of NPLs were taken off the books of SOCBs as part of the recapitalization process and transferred to an Asset Management Division of MOF. This amount included for about 80 percent loans to state-owned enterprises (SOEs), 16 percent, loans to the private sector and 4 percent, loans to cooperatives. The responsibility to recover the loans was shared between MOF and the banks (with little incentive) in collaboration with the Credit Department of BOL. According to BOL, over six years, collection amounted to Kip 1.9 billion, i.e., 13 percent. This is not such a bad result when compared to other countries which had similar problems. Unfortunately, Government directed lending continued, banks’ lending practices did not improve and management of SOEs did not change; as a result more non-performing loans crept into the loan portfolios of the recapitalized banks.

81. The lessons of this experience have yet to be fully articulated. Those lessons must be learnt and shared as they should be a major input into any future design of a process to collect non-performing loans. Three main questions remain to which only partial answers are available. First, are the current defaulting borrowers the same as those who were in default in 1994? To some extent this is the case: some largest current NPLs were also NPLs in 1994. Second, to what extent recovery of bad debts in the previous recapitalization occurred through the sale of assets of the defaulting borrowers? According to interviews, in a minority of cases, banks went to Court and in a few instances obtained seizure of assets. Third, to what extent those responsible for systemic insolvency were sanctioned in the 1994 round of recapitalizations? About half of the borrowers responsible for NPLs disappeared. Efforts to design an adequate process to collect NPLs would be much facilitated by having precise information on all of these points.

---

D. THE LEGAL FRAMEWORK AND JUDICIAL ENFORCEMENT

82. As far as the financial sector is concerned, the Lao Constitution is very supportive and the laws are somewhat supportive. In addition, the Government also enacts decrees and regulations and increasingly notices in areas not always covered by the laws decrees or regulations. Some laws create problems or have deficiencies, and there are gaps and inconsistencies. Narrow and restricted dissemination of legislative acts and regulations is responsible in part for the lack of compliance and uncertain outcomes when rights are to be protected. Finally, existing laws are not forcefully and systematically applied and judgments enforced as the judiciary function remains weak. Unfortunately, private sector activity—on which the Government may rely to generate the target economic growth (see Chapter 1)—is generally deterred in such an environment.

1. The Constitution

83. The 1991 Constitution of Lao PDR is clear on good governance transparency, and dissemination. Article 6 stipulates that “The State protects the inviolable rights and democratic freedoms of the people. All state organizations and functionaries must inform the people of and educate them in the policies, regulations and laws, and together with the people, to implement them in order to guarantee the legitimate rights and interests of the people. All acts of bureaucratism and harassment that can be detrimental to the honor, body, lives, conscience and property of the people is prohibited.”

84. According to Article 10 “The State manages the society by the provisions of the Constitution and the Law. All Party and State organization... and citizens must comply with the Constitution and the law.” Furthermore, the Constitution sets fundamental principles everybody can agree to. Article 14 states that “The State protects and promotes all forms of state, collective and individual ownership, as well as the private ownership of both domestic investors and foreign investors who invest in the Lao PDR. The State encourages all economic sectors to compete and cooperate with one another.... All economic sectors are equal before the law.”

2. The Lao Laws, Decrees and Notices

85. Laws are adopted by the National Assembly while the Implementing Decree and regulations are issued by the executive branch. But often neither implementation decrees nor regulations are issued or are issued only after an extended period of time and long debate. Only “Notices” which are issued by the Prime Minister and are in the hierarchy of legal norms obviously lower than a law which require National Assembly’s approval, are issued regularly. Notices may have little reference to the existing body of texts hence creating inconsistencies. A good example is the Foreign Investment Law (FIL). Since the FIL was adopted in 1994 other laws regarding Private Sector Development (PSD) have been adopted. Moreover decrees have

---

26 The Prime Minister is issuing the Decrees—implementing the laws and empowering relevant public bodies to issue the detailed regulations—the Minister or equivalent bodies issuing the detailed regulations such as decisions, approval and notices. The President of State promulgates law by decree of the PR and Decree Laws in between sessions of the National Assembly. According to the Constitution of Lao PDR such Decree Law should be submitted to the next session of the National Assembly for approval, to our knowledge this never happened.
been adopted on specific issues. Finally “notices” have been issued and only such notices are really enforced by the staff in the line Ministries, at least for a while.

86. The Land Law is a case of a Law creating some difficulties for the financial sector. The 1996 Land Law has not solved some issues (right to use vs. ownership) and did not clarify entitlements to land user rights and procedures for establishing and enforcing those rights. It created difficulties with the cap on how much land rights one can own which leads to much uncertainty when the ceiling will be implemented during year 2000. Uncertainty is obviously detrimental to the financial sector because risks cannot be managed; it is therefore detrimental to the private sector development and more specifically to foreign direct investment, as clearly established rights are the foundation of any investment. The Law on Enterprise Bankruptcy (6/94 dated October 14 1994) is also an example of law creating problems: before any creditor can lodge a petition for the declaration bankruptcy of an indebted enterprise “the creditors must have claimed three times within intervals of no less than 20 days between each claim and the indebted enterprise must have acknowledged their receipt and failed to reimburse” (Article 5). Therefore if the troubled business does not acknowledge the receipt of the claims, it is shielded from the bankruptcy procedure as the creditor cannot lodge a valid petition with the Court.

87. Other difficulties are illustrated by the FIL. The Law was enacted in 1994 but the Implementing Decree only in 2001 (Decree No. 46/PM dated April 23 2001). During that seven year period, the existence of the Business Law and its implementing Decree No. 31/PM dated February 1, 1996 created some uncertainty as to whether all sectors were really opened to foreign investments and what were the detailed procedures and responsibilities among the various entities in charge of processing applications. Prior to the implementing Decree, the Decision 28/PM dated August 18, 2000 also clarified the roles duties and responsibilities of the Management Committee for Foreign and Domestic Investments and for International Cooperation (CIC) and more precisely the role of the Foreign Investment Management Committee (FIMC).

88. The Contract Law states that before going to court, parties to a contract disputes should first seek to settle through mediation. This is the preferred way in the Lao culture. But the Contract Law does not establish general principles of contractual obligation, enforceability and remedies which makes mediation difficult. In addition, the Arbitration decree maps a long process including many steps and intermediaries before a settlement can be reached hence defeating somewhat the original intent and setting the ground for governance issues. It is also ill-suited for large conflicts.

89. The lack of adequate dissemination of laws, regulations and notices is most damaging. In the early nineties, laws and regulations were published in the state-owned newspaper; for over a year, the Ministry of Justice published an Official Gazette. This system ensured at least dissemination of the laws and some Prime Minister Decrees. Nowadays there is only sporadic printing in newspaper takes place, discussions on the national radio and word of mouth indicate that “something new came up.” Despite Article 10 of the Constitution which stipulates that the

---

27Article 15 of the Constitution states that the land is under the ownership of the national community but rights attached to the land appears to be ownership as one can use transfer and inherit those rights.

28In the hierarchy of Lao legal norms the sequence by importance is Constitution, Law, Decree, Decision…. Which is consistent with global practices.
“State manages by the provision of Laws”, more and more “notices or instructions” are issued. But notices are difficult to obtain even though obviously important as they provide clarifications to officials and civil society alike, and may indicate shifts in policies as it was recently the case. Examples are the restoration of the licensing process for import was a Notice of the Prime Minister, or the Instruction related to the “Improvement of State Enterprises to Achieve High Efficiency” (Prime Minister’s Office No.19/PM, dated October 19, 1999).

90. This is all the more important because notices really are implemented even if they were not consistent with laws, although they tend to fade away with time. To be noted that, since recently, the Ministry of Justice ensures that notices are consistent with the Laws and Decrees.

91. This lack of dissemination and knowledge of the law creates uncertainty as the interpretation of the Law is done on a case by case. This creates incentive conflicts for some officials\textsuperscript{29} which has been noted on many occasions resulting in the recent issuance of a decree on corrupt practices. The recognition of intellectual property is weak illustrating a gap. The Decree No.6/PM on trademarks was issued on January 18 1995 but remains unknown. Recently, Oxford Analytica published a legal assessment indicating that Lao PDR, among other Asian countries, has no Copyright regulations which is correct. But the publication failed to indicate that there is a Decree on trademarks and a Decree on Patents has been drafted.

3. Two Critical Laws for the Financial Sector: The Bankruptcy Law and the Secured Transaction Law

92. In collaboration with experts from numerous partner organizations, the World Bank has recently formulated \textit{Principles and Guidelines for Effective Insolvency and Creditor Rights Systems} which are a distillation of best international practice in these fields. These \textit{Principles} provide a useful conceptual framework for analysis of existing and proposed creditor rights and insolvency legislation in any country. They embody several underlying propositions:

- Effective insolvency and creditor rights systems respond to national needs and problems. As such, these systems must be rooted in the country's broader cultural, economic, legal and social context.

- Transparency, accountability and predictability are fundamental to sound credit relationships. Capital and credit, in their many forms, are the lifeblood of modern commerce. Investment and availability of credit are predicated on both perceptions and the reality of risks. Competition in credit delivery is handicapped by lack of access to accurate information on credit risk and by unpredictable legal mechanisms for debt enforcement.

- Legal and institutional mechanisms must align incentives and disincentives across a broad spectrum of market-based systems, commercial, corporate, financial and social.

93. Based on these \textit{Principles}, the October 1994 Secured Transactions Law of the Lao PDR appears deficient in important respects. A secured transaction law aims to ensure that those

\textsuperscript{29}The National Audit Office was established at the Prime Ministers Office in parallel to the Inspection Board of the Party and November 2, 1999 Decree No.193/PM on Corruption was signed by the Prime Minister.
providing financing for transactions receive appropriate security which can be efficiently enforced in the event of default and that all who are interested (especially future sources of finance) can readily, and inexpensively, receive complete and accurate information of any prior secured interest in any property. The Lao PDR statute, however, allows so-called "guarantees by law" and "guarantees by court decision" to have priorities higher than what is afforded to normal security (such as pledges, liens and mortgages) flowing from standard contractual banking/credit arrangements. By definition, these priority "guarantees" cannot be registered in advance and thus put at unreasonable risk the security taken by financial institutions in exchange for their loans. Also, the statute makes no provision for any notice of secured interests.

94. Although the existing corporate insolvency regime properly provides for a liquidity (rather than a balance sheet) test for insolvency, as well as a framework for the rehabilitation of enterprises in financial difficulty, when measured against the Principles, the October 1994 Law on Bankruptcy lacks essential features of a model legal framework for corporate insolvency. Among other weaknesses are the lack of: (a) provisions for the equitable treatment of similarly situated creditors; (b) transparent procedures with incentives for the gathering and dispensing of information regarding debtors; (c) clear and appropriate membership requirements for all relevant committees; (d) clear guidance regarding the disposition of assets at maximum values; (e) provisions dealing with interference with contractual obligations that are not fully performed; (f) rules of priority which support incentives for creditors to manage credit efficiently; and (g) features which would help to stabilize and sustain business operations during the rescue process.

4. The Judicial Process and Enforcement

95. Not surprisingly enforcement is difficult in this unclear legal framework or as the President of the People’s Supreme Court put it “understanding of and interpretation of the laws is not yet clear and uniform.” Some officials do not refer to the law in making their decisions. As the laws, regulations and notices are not available as a full set, the Magistrates backing their judgment essentially on their common sense and professional conscience, may rule in an inconsistent way with the law, therefore creating precedents, frustrations and reluctance to go to the Courts. For example, in a joint venture “Public Company” Lao Foreign regulated by the FIL, one of the Lao partners Mr. K. owned 41 percent of the shares the other partners Lao and Foreign 51 percent. The majority of shareholders decided that Mr. K. would no longer be a Board member. Mr. K. complained to a Government representative who felt that Mr. K. was right because “he owns many shares.” A legal solution is in the Business Law article 60 to 76 referring to Public Companies which stipulates that the majority decides.

96. The judicial system is unpredictable and slow. Although the Ministry of Justice has issued a “judicial bench-book” in 1999, the Magistrates have little relevant training and knowledge of business and finance to be able to professionally rule in such areas according to the laws. Some training does take place but it is generally conducted abroad and therefore not necessarily consistent for the Lao Law. This illustrated by the fact that a very small number of

---

30Report from the President of the People’s Supreme Court regarding the undertakings of the People’s Courts in adhering to the Constitution and Laws after the 7th Ordinary Congress of the National Assembly, 3rd session, October 1995.
cases reach the Court. According the Deputy Minister of Justice, in Vientiane municipality 8-15 civil cases each month. (*Vientiane Times August 10 2001*).

97. The Arbitration process is also time consuming to meet the needs of the financial and business sector. The arbitrators are not specialized and would probably not be able to resolve disputes on financial and banking issues for example. Some contracts include resolution of conflicts in International Arbitration Courts or foreign commercial courts.

---

**Box 1.**

**Diagnostic of the Lao Legal and Judicial System**

The coexistence of different sources creates problems. Internally, there are contradictions between some ministerial decrees and legislative texts. Theoretically, the decrees cannot contradict the law. However, most of them are useful or necessary to economic or social policy. Consequently, it would be suitable to validate them in accordance with the Constitution.

International sources also create problems. Lao PDR signed (ASEAN) and intend to sign (WTO) a number of international treaties. Some Lao laws need to be adapted to the clauses of the international treaties. For instance, some Lao laws need to be updated in the area of trade liberalization.

In Lao PDR most texts in force and most decrees have never been published. This situation creates a legal uncertainty which might discourage investments.

The Investment law in force since 1994 grants privileges to foreign investors approved by an ad-hoc administrative authority. But it also involves a long bureaucratic process that might discourage investors. In the context of economic liberalization, an equal treatment for foreign investors and domestic investors is expected.

Investment lending is essentially based on collateral provided by the borrower to guarantee the debt. This type of credit relies on the efficient implementation of the Guarantee Law. Despite an adequate law, its implementation is made inefficient in part because the publication of guarantees is not adequately regulated. Working capital lending relies on the discount of bills of exchange. But the 1998 decree on bills of exchange have still not yet been disseminated.

The 1990 law on property defines five types of properties (state property, joint property, individual property, private property, and personal property). According to this law, the acquisition of a property only becomes effective after the registration of the deed of transfer. Thus, it is registration that transfers property and not the contract. Registration depends on a precise cadastral delimitation which is long and expensive to obtain in Lao PDR.

In the context of commercial disputes settlement, only official written or authentic documents are recognized in Lao PDR. To be valid, the documents must be signed by the Village Chief. In addition, it is being considered that to be valid documents should be notarized. This is a lengthy and expensive process which is not compatible with business practices.

Currently appeal cases go to the Supreme Court.

Courts are not supported by auxiliary services to ensure that the debtor does not sell his belongings while the legal procedure is in motion and to enforce a court decision in case of refusal to comply.

---

*aExtract of the Executive Summary from “Rapport Final de Mission” from R. Garron and E. Putman, Professors at Faculté de Droit d’Aix-Marseille. April 2000. (Unofficial translation).*
CHAPTER III. DESCRIPTION OF THE FINANCIAL SYSTEM

98. Chapter II described and analyzed the rules and the incentives in place for the financial system in Lao PDR and how they are implemented. Chapter III describes the system which emerged in such an environment. It shows that the Lao financial system is small, undiversified with a limited number of different institutions, dominated by public commercial banks with only a few non-bank financial institutions including microfinance institutions.

A. THE BANKING MARKET: SMALL AND DOMINATED BY STATE-OWNED BANKS

99. At year end 1999, the banking system in Lao PDR comprised (a) four state-owned banks including the Agriculture Promotion Bank (APB), (b) three joint-venture banks,31 (c) seven branches of foreign banks, and (d) one representative office. These banks are commercial banks except for APB, a policy bank, primarily geared towards development banking for agricultural and rural development, but also performing commercial banking operations.

<table>
<thead>
<tr>
<th>Type of Institution</th>
<th>Number</th>
<th>Assets (US$ million)</th>
<th>Assets in % of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>State-Owned Banks</td>
<td>4</td>
<td>289</td>
<td>70.7*</td>
</tr>
<tr>
<td>Foreign Branches</td>
<td>7</td>
<td>85.5</td>
<td>20.9</td>
</tr>
<tr>
<td>Joint-Venture Banks</td>
<td>3</td>
<td>34.0</td>
<td>8.3</td>
</tr>
<tr>
<td>Representative Office</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>15</td>
<td>408.4</td>
<td>100</td>
</tr>
</tbody>
</table>

*APB’s assets account for about 5 percent of total assets in the banking system.

100. The Lao banking sector is small in absolute terms, with total assets in the system amounting to approximately US$408 million. But small size is not a curiosum applying to a handful of countries. Many financial systems are extremely small: about 60 countries have financial systems each of whose total size (measured in terms of M2) is less than $1 billion, no larger than a small bank in an industrial country. (See Figure 12 from “Size of Financial System” by B. Bossone, P. Honohan and M. Long, World Bank May 2000.)

101. Furthermore, the Lao banking sector is also relatively small when compared to the size of Lao economy: the ratio of total assets of the banking system to GDP is about one-fourth. This is particularly low for an economy with a non-diversified financial system (i.e., with no alternative but banks to supply loans) and it evidences a system in its early stage of development. This ratio can be compared with a ratio of 80 percent in Thailand where the financial sector is much more diversified.

---

31 The Lao-Viet Bank, the joint venture bank invested by the BCEL and the Bank for Investment and Development Bank of Vietnam, was opened on June 22, 1999.
102. State-owned commercial banks dominate the market with more than two-thirds of the total assets. The three largest banks (BCEL bank, Lao May bank, Lane Xang bank) are fully owned by the government; BCEL maintains a dominant position accounting for approximately half of total deposits, and almost 40 percent of total loans in the system. For a financial analysis of BCEL and APB, please see Annexes 3 and 4.

### Table 3.
**Banking Sector Development: International Comparison**

<table>
<thead>
<tr>
<th>Country</th>
<th>Domestic credit provided by the banking sector/GDP (%) (1997)</th>
<th>Share of state-owned banks in total bank assets (%) (1996)</th>
<th>Credit to SOEs /total domestic credit (1996)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malaysia</td>
<td>165</td>
<td>8</td>
<td>-</td>
</tr>
<tr>
<td>Thailand</td>
<td>140</td>
<td>7</td>
<td>3</td>
</tr>
<tr>
<td>China</td>
<td>106</td>
<td>82</td>
<td>82</td>
</tr>
<tr>
<td>Korea, Rep.</td>
<td>86</td>
<td>13</td>
<td>1</td>
</tr>
<tr>
<td>Philippines</td>
<td>85</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>Indonesia</td>
<td>58</td>
<td>48</td>
<td>3</td>
</tr>
<tr>
<td>Poland</td>
<td>37</td>
<td>-</td>
<td>18</td>
</tr>
<tr>
<td>Russian Fed.</td>
<td>26</td>
<td>-</td>
<td>14</td>
</tr>
<tr>
<td>Vietnam</td>
<td>23</td>
<td>80</td>
<td>57</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>11</td>
<td>66*</td>
<td>40**</td>
</tr>
</tbody>
</table>

*Share of total assets of the four SOCBs in total bank assets, and credit to SOEs extended by four SOCBs as a share of their total credit, December 1998. (Source: World Bank, BIS, and staff estimates.).

**1999.
103. The Lao banking system is characterized by a marked geographical concentration in banking services in Vientiane and large cities. This concentration is likely to increase. The ongoing bank restructuring program consolidated six national and regional state banks into two state-owned banks of comparable size, Lao May Bank and Lane Xang Bank. The rationale for the mergers includes cost savings and the closure of unsustainable branches. The mergers would make it easier to improve management and make better use of scarce managerial and banking skills in the country.

---

**Box 2. Joint-Venture Banks and Foreign Branches in Lao PDR**

Private banks comprise of 3 joint-venture banks, 7 branches of foreign banks (6 Thai and 1 Malaysian), and a foreign bank representative office. Foreign banks are only allowed one branch in Vientiane. Branches of foreign banks are wholesale banks: their major clients are foreign companies or subsidiaries and affiliates of foreign companies. Given the current economic environment, foreign branch activities have only been funding the working capital of Thai and Malaysian manufacturing and trading firms operating in the Lao PDR.

**Joint-Venture Banks**

Joint Development Bank was established 10 years ago between Thai investors and the Bank of Lao, which has a stake of 30 percent. Unlike the state-owned banks, Joint Development Bank does not enjoy any support (i.e. funding) from BOL. JDB is technically insolvent with recapitalization needs of more than US$6 million.

Vientiane Commercial Bank is a local bank established in 1992 with a paid up capital of US$5 million owned by Lao Australian, Thai, Taiwanese and Lao investors. Foreign shareholding is 80 percent. Among its major clients are affiliates and other businesses of its shareholders (Lao Plaza). It does not consider its banking business profitable. It has a staff of 40. According to management, NPLs amount to 1 percent.

Lao-Viet Bank, a 50-50 joint venture between BCEL and the Bank for Industrial Development of Vietnam with authorized capital of $10 million, has been in operation since June 1999. It was formed in the spirit of economic cooperation and mutual friendship between Laos and Vietnam. Lao-Viet Bank will be the only bank authorized to convert Kip to Vietnamese Dong.

**Foreign Bank Branches**

Bangkok Bank is one of the six Thai banks with a branch in Vientiane. The branch, established in 1993, has a registered capital of $5 million. It caters to large depositors comprising companies and high net worth individuals. Borrowers are corporations, mostly Thai companies doing business in Laos. It concentrates on trade financing. Most of its income is fee-based earned from foreign exchange and trade bill transactions and its credit card business. Bangkok Bank has been downsizing its operations. The nonperforming loans of the Bangkok Bank branch are reported to be 5 percent.

The other five Thai banks with branch offices in Vientiane are Krung Thai Bank, Thai Farmers Bank, Thai Military Bank, Siam Commercial Bank, and Bank of Ayoudhya. Thai banks concentrate on trade financing and corporate lending (short-term and working capital).

Public Bank is a branch of a Malaysian bank focusing on garment manufacturing. Public Bank is conservative in its lending operations. It has no unsecured loans. It is considered to be the best managed bank in Laos. It has a core staff of 14, comprising 2 Malaysians and 12 Laotians, all of whom speak fluent English.

**Representative Office**

Standard Chartered Bank has a representative office in Vientiane since January 1996. It provides offshore trade finance up to 180 days. It planned to upgrade its operations to a branch in 2000 but recently, decided to maintain just a representative office in view of the weak economic conditions.

---

32 Lao May Bank Ltd. is the result of the “southern” merger of the old Lao May Bank, Phak Tai Bank and Nakhoneluang Bank, while Lane Xang Bank Ltd. is the result of the “northern” merger of the old Lane Xang Bank, Aroun May Bank and Settathirath Bank.
104. The Lao banking system enjoys a certain degree of openness. There are three joint-venture banks (one private, one mixed and one jointly owned by Lao PDR and Vietnam), seven branches of foreign banks, and a foreign private bank representative office. Thai banks dominate as six out of seven foreign bank branches are Thai bank branches. This concentration makes Lao PDR more vulnerable to shocks to the Thai economy and may limit transfer of banking expertise. (See Box 2).

105. Foreign banks are only allowed one branch in Vientiane: their major clients are foreign companies or subsidiaries and affiliates of foreign companies. Given the current economic environment, foreign branch activities have essentially been funding the working capital of Thai and Malaysian manufacturing and trading firms operating in the Lao PDR. Furthermore, with their current home country problems, the majority of foreign banks are not in the mood for expanding.

B. NON-BANK FINANCIAL INSTITUTIONS

106. There are only few non-bank financial institutions (NBFI) in Lao PDR, evidencing a narrow, i.e., undiversified financial system where there is still limited alternative to banks for access to financial services. The microfinance system is emerging; there is only one insurance company; and the Social Security system is still in its infancy with little or no accumulated financial surpluses.

107. Institutions such as leasing companies which base their lending on future cash-flow of a rented asset, rather than on past performance and collateral, are missing. Life insurance institutions providing long term capital are also lacking. There is no capital market or arrangements providing equity or debt or standardized debt contracts.

1. Microfinance

108. Microfinance, i.e., the provision of financial services (saving, credit, insurance…) to poor people (in rural and/or urban areas) through specialized sustainable institutions, is an important piece of the financial system in a country such as Lao PDR where the majority of the people does not have access to formal financial services: 80 percent of the population lives in rural areas and 90 percent of that population do not have access to formal banking services. Furthermore, it has been demonstrated that microfinance is an effective tool to fight poverty and Lao PDR is a poor country with GDP per capita standing at around US$400 per year. But in Lao PDR, the microfinance industry has only started to develop in the last four years and is still limited compared to other countries in the region such as Cambodia, Indonesia and Philippines. But if the Lao microfinance industry integrates lessons learnt and best practices, benefits from a good environment and an improved formal financial sector, it could contribute significantly to Lao development and poverty reduction.

109. Despite a large demand for microfinance services and in particular for savings, the supply of such services still remains low. Estimates show that only 25 percent of potential micro-borrowers and potential micro-depositors have access to micro-financial services. (See Annex 5 for an explanation of these estimates).
The Lao microfinance system is currently at an infant stage with five different types of suppliers. Firstly, the Agricultural Promotion Bank (APB)—the Government owned policy bank—focuses on the agricultural sector: APB promotes specific sub-sectors and lends at subsidized rates. Secondly, Lane Xang bank, an SOCB, started micro-lending recently with a focus on micro-traders. Thirdly, Village Revolving Funds (VRF): there are approximately 1,600 VRFs, mostly donor funded with limited outreach. Fourthly, three microfinance initiatives with no more than 2,500 active borrowers each. Finally, fifth, numerous money lenders offering loans at usury rates. (See Annex 5: Main features of Suppliers of Micro-credit in Lao PDR). The recent pilot development of MFIs through a Government executed project shows that it is possible, with adequate interest rates, to implement sustainable microfinance schemes in Lao PDR: repayment rates exceed 99 percent.

Lao PDR presents many challenges that explain why microfinance is difficult to implement. The outreach of each MFI is limited due to the low density of population; this results in higher unit transaction costs making it more difficult to become sustainable. The local infrastructure, mainly roads, are in bad conditions which render access to villages difficult and increase transaction costs further, especially during the rainy season. The capacity is low and it takes significant resources to train candidates to manage MFIs. There are few local institutions which can be built up. Most credit and saving cooperatives were unsuccessful in the early nineties. Even donors in Lao PDR are also responsible because they have limited experience and knowledge in microfinance best practices: they promote and continue to fund projects which often cannot become sustainable.

A wider understanding of the advantages of sustainable microfinance is still needed among policy makers to improve the policy environment. The nascent microfinance sector also competes with subsidized credit. There is an uneven playing field in the micro-lending business making it even more difficult for sustainable MFIs to emerge. APB is lending at very low (subsidized) interest rates incompatible with cost recovery and sustainability. It is funded mainly by BOL and other SOCBs. For a complete discussion of agricultural financing, please see Chapter V.

The existing regulation on credit cooperative does not leave space for different models to emerge. Regulation 02/SB from BOL dated November 19, 1994 regulates credit cooperatives. This text is thorough in certain aspects but does not address important issues (such as investment of funds, loan write-offs, fixed assets, liquidity management, records preservation, external audit, loan portfolio concentration, provisioning…) and applies to sophisticated institutions. As a result only one institution has registered under this regulation. This regulation also restricts sustainable project exit options. However, through its Microfinance project, the Government is currently reviewing the constraints of regulating and opportunities for improving the regulatory framework: recommendations were formulated such as a step by step approach on regulation.

33 Cooperative de Credit de Soutien aux Producteurs (CCSP); Microfinance Project (MFP); Projet de Developpement Decentralise de Phongsaly (PDDP).
2. Non-Life and Life Insurance Industry

116. This is a one-company industry. Prices and indemnities are controlled. Technical reserves are invested in term deposits only.

117. The insurance industry is regulated by the 1990 Insurance Law (11/90) which was inspired by the French insurance law and an implementing decree (No. 1/PM) dated January 23 1992. The Ministry of Finance with a staff of two, is in charge of supervising the industry and getting the prudential rules implemented.

---

**Box 3.
Typical Microfinance Story**

(Excerpt from an article written by Microfinance advisors for Lao Students)

It is 6:30 PM in Paklay, in the province of Sayaboury. Kamla and her husband Somboune, a couple of Lao farmers, are talking over dinner on how to improve their living conditions and make a real change in their income. They have always dreamt of building their own house and sending their children to school. They have several ideas on traditional activities that could increase their revenues such as poultry raising and textile weaving. What do they need to put their plan into action and finance such projects?

Kamla and Somboune only have small savings under their mattress and the formal banks believe they do not have appropriate collateral to get a loan. Due to the current severe economic situation, the extended family cannot lend them any cash. Yesterday, Kamla went to the market and talked to the moneylender. He will lend her 1,000,000 kip for six months with interest worth 200 percent for the period. Like most Lao farmers, she cannot afford to borrow at such a high cost.

Kamla learns from a friend that the Agricultural Promotion Bank and the Lao Women’s Union have just launched a special Microfinance project serving the poor in Paklay. Somboune and Kamla decide they will go and visit the Microfinance project manager to get a loan. If neither the family, the bank nor the moneylenders can help them, maybe Microfinance will help them...

When Kamla and Somboune go and visit the project, they will learn that they first need to form a saving and credit group with other villagers and deposit regularly savings. This will enable them to borrow a small amount of cash (US$35 equivalent for six months) that they will have to repay with interest bi-monthly. The loan will usually finance traditional activities generating income such as poultry raising, rice trading, or purchase of stocks for trading activities. Once they have demonstrated their repaying capacity, Kamla and Somboune will be able to apply for a Micro-enterprise loan. Once they have accumulated sufficient collateral for getting a formal loan, they might apply for a loan from a commercial bank.

There are more than 170,000 households, that is about one million people, who could benefit from microfinance services in Lao PDR.

---

This article was written in 2000 by Mr. Eric Duflos, Microfinance Advisor and Coordinator for “The Microfinance Project (MFP)” – GOL/UNDP/UNCDF, in cooperation with Mr. Kurt MacLeod, Senior Microfinance Advisor for Pact.
118. Assurances Générales du Lao (AGL) was established 1991 and is still the only licensed Lao incorporated insurance company. AGL is a joint venture between State of Lao (49 percent) and Assurances Générales de France (51 percent) now part of the Allianz Group. It benefited from an initial 3-year official monopoly. Today AGL remains the only insurance company. AGL’s non-life insurance accounts for 90 percent of its business and car insurance accounts for 40 percent of collected premiums. Prices and indemnities are controlled. With recent high inflation rates, amounts have become almost meaningless as they are not revised.

119. Total premiums collected amounted to Kip 11 billion (US$2.5 million) in 1998. AGL posted a 15 percent operational profit. However, its net result of 60 percent of sales in Kip was due essentially to capital gain on equity kept in US dollar. AGL paid taxes on the net profit hence depleting its capital base. Technical reserves are entirely deposited in domestic banks (BCEL essentially) and abroad in up to one-year term deposits in Kip and other currencies. AGL has decided not to invest any part of its technical reserves in real estate in Vientiane.

3. Social Security in Lao PDR

120. The impact of the social security system on the financial sector is negligible and may remain so in the coming years. The system is currently being in part reformed and in part redesigned. It is likely that no significant financial surpluses will be accumulated soon.

121. For the public sector, social security and pay-as-you-go pension systems were introduced a few years ago. Since December 1989, all civil servants are required to contribute 6 percent of their salary to the “Social Security Fund” which provides comprehensive protection including pension, child allowance, invalidity from war, medical care, death, maternity and sickness. This Fund is managed by the Social Security Department, Ministry of Labor and Social Welfare (MLSW). The Government provides annual budgetary support to supplement the employees’ contributions as needed to meet expenditures. In the first 9 months of FY1999, the Government paid about Kip 16 billion to support the Fund. In the past 2 years, about 70 percent of the Fund expenditures came from the Government. The system will be reformed in the near future as it is government’s intention to establish a funded pension scheme and separate it from the social security fund.

122. For workers in state-owned enterprises and private sector companies with 10 or more workers, a social security system is being implemented gradually on compulsory basis since mid-2000. Smaller companies can voluntarily join the system. The system will provide health care and disability benefits, and pensions. The system should be self-financing. In September 2000 the contribution rate was set at 9.5 percent of total earnings of the worker, shared by the employer (5 percent) and employee (4.5 percent). The Social Security Organization (SSO), an autonomous institution under the MLSW set up on June 30 2000, manages four separate funds, one for each type of benefit: health care, pension, injury and disability and short-term benefits. Initially, the SSO will receive its budget from the government. The registration of employers started in November 2000 for enterprises with 100 or

---

34 Indochine Insurance, a Cambodia-UK joint venture, with head office in Phnom Penh, has set up a representative office in November 1999. As of August 2001, it does not conduct any business yet.
more employees in Vientiane municipality and the first contributions were collected in June 2001.

4. The Leasing Industry in Lao PDR

123. Leasing is a tool well adapted to the needs of new, small and medium-sized enterprises with no financial history: a leasing decision is based on future cash-flows generated by the leased asset rather than on historical performance of the borrower. Furthermore, it is also adapted to countries where the judicial system is weak as repossessing an asset in the case of non-payment is generally easier.

124. In February 1999, the Government issued a Leasing decree (No. 11/PM) which sets the legal framework for the development of financial leasing in Lao PDR. The decree requires that a finance lease company be licensed by the Bank of Lao PDR (BOL). Licensing conditions are (a) to be a juridical entity; (b) to have entered in at least six duly registered written leasing agreements in a year; (c) to have a minimum registered capital of Kip 500 million; and (d) to have a sound financial condition and staff with skills in leasing activities and business experience. These normal requirements restrict the qualified applicants to foreign leasing companies, and joint venture companies with foreign partners engaged in leasing. This is not necessarily a negative feature as there is currently no local capacity in that area.

125. The Leasing decree states that finance lease companies are to be supervised and regulated by the BOL but prudential norms have yet to be established. Submission of audited annual reports to BOL is required, and accounting must follow the enterprise accounting law. The basic regulatory framework for leasing must recognize that it is a distinct form of financing and must ensure that leasing is subject to an equal treatment. An area that may need more investigation is the tax law applicable: tax laws must clearly define the tax obligations and tax credits (including depreciation) that the parties to a lease expect to incur. This allows a potential lessee to evaluate the cost of a lease and compare it to other sources of equipment finance.

126. Funding adequately the leasing activity will not be easy in Lao PDR. Medium-term funds are scarce and until the Lao financial sector develops, it is likely that finance lease companies will have to mobilize offshore funds. Raising funds through issuance of financial instruments such as promissory notes domestically or raising funds offshore, requires BOL approval. In addition, raising funds offshore will require approval by the Foreign Investment Management Committee under the Office of the Prime Minister.

127. Yet presently, almost two years and a half after the Leasing decree was promulgated, no one in Lao PDR is involved in leasing operations. It appears that the main reason is a lack of understanding of the advantages of leasing. Except for executives of the foreign bank branches that have affiliates at home engaged in leasing, domestic bankers know little about financial leasing and domestic banks have yet to express any interest to develop a leasing business.

128. Reflecting the sector’s potential, leasing volume has been growing rapidly in developing countries, where new leasing contracts covering $44 billion-worth of assets were signed in 1994 (accounting for 11 percent of the financing costs of capital equipment), up from $15 billion in 1988. (Source BIS).
**CHAPTER IV. FUNCTIONAL ANALYSIS**

* A Banking Industry in Distress

129. After Chapter II analyzed the institutional and policy environment, and Chapter III described the financial system which then emerged, Chapter IV assesses how the basic financial functions are performed by the Lao financial system. This Chapter IV shows that the resulting financial system, dominated by public banks is unable to perform most expected functions and is arguably in a difficult situation.

**A. INTRODUCTION**

130. The arising of a financial system is justified by the existence of market frictions that include the costs of acquiring information, writing and enforcing contracts and costs of trading goods and financial contracts. Financial contracts, financial markets and financial intermediaries arise to mitigate these frictions and that is how the financial system adds value.

131. The financial system performs five functions: (a) mobilize savings; (b) research and allocate capital; (c) exert corporate control; (d) facilitate trading of goods, services and financial contracts; and (e) facilitate trading, hedging and pooling of risks. We will now review how these functions are performed in Lao PDR.

**B. DEPOSITS MOBILIZATION AND BANKS’ RESOURCES**

132. There are many reasons why saving mobilization is low in Lao PDR, starting with a low initial pool of savings. Nevertheless, deposits constitute the main resource of Lao commercial banks, accounting for more than 55 percent of total liabilities.

1. Deposit mobilization

133. Mobilizing savings from many disparate savers is costly for two reasons: collecting savings from many different individuals is costly and the “mobilizer” must make savers feel comfortable in relinquishing control of their savings to him.

134. In Lao PDR, saving mobilization is a function which is not well performed by the financial system. But it truly is a difficult task. Some reasons appear to be intrinsic to the country while others result from policy choices.

135. At the end of 1999, the main characteristics of savings, deposited in bank accounts (Kip 1.9 trillion or US$237 million equivalent\(^{35}\)) were the following: overwhelmingly (a) from urban areas (more than 90 percent), (b) in foreign exchange (more than 80 percent), (c) in State-Owned Banks (more than 80 percent), and (d) almost equally shared between individuals and corporations. (See Table 4.)

---

\(^{35}\)End of December 1999 at Kip/US$ rate of 7,600.
Table 4.
Structure of Lao banking deposits
(December 31, 1999)

<table>
<thead>
<tr>
<th></th>
<th>SOCBs</th>
<th>Other Banks</th>
<th>Kip</th>
<th>Foreign currencies</th>
<th>Individuals</th>
<th>Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>80%</td>
<td>20%</td>
<td>15%</td>
<td>85%</td>
<td>48%</td>
<td>52%</td>
</tr>
</tbody>
</table>

136. Currency outside banks accounted for approximately 5 percent of broad money. This is a low figure taking into consideration the underdeveloped payment system and limited outreach of the banking system which force people to hold higher balances of cash for everyday expenditures. However, this number is probably underestimated due to the difficulty of measuring non Kip holdings.

137. **Low mobilization can be attributed partly to the banking systems.** Certainly the limited outreach of the banking system is contributing to a low mobilization of savings. In the rural areas, the amount of cash savings which is not mobilized by the system, is estimated to amount to US$45 million equivalent. But this is not surprising in a country where less than 25 percent of the population lives in urban areas, where population density is below 20 persons per kilometer square: the costs of mobilizing deposits are very high. Furthermore, this is combined with limited infrastructure (such as roads or electricity), increasing still the cost of doing business.

138. Unfortunately, the Lao microfinance system is not well developed either and focuses essentially on credit distribution (most donor subsidized VRF with no savings services) as opposed to balanced emphasis on mobilization of deposits and credit. The bridges between the formal financial system and the semi-formal or informal systems have yet to be built and until microfinance schemes are designed as sustainable institutions rather than as social funds, this will be difficult.

139. Where payment infrastructure is underdeveloped, people make limited use of payment instruments such as checks or wire transfers. This feeds a need for holding high cash balances outside the banks further limiting their resources. In addition, barter trade is still widely practiced in Lao PDR.

140. The low level of confidence in the local banking system and in the currency creates (a) a disincentive to deposit money in banks which provide substantial amount of credit to SOEs (which may be suspected to be inefficient) and (b) an incentive to hold foreign exchange accounts (about two-thirds of broad money is Thai bath and US Dollars), in another country whenever possible. This low level of confidence is also evidenced by the quasi 50/50 ratio between individual depositors and firms. Generally, firms have no choice but to have bank accounts. This is not the case with individuals who can choose not to have a bank account. In more developed countries this ratio stands at about two-thirds for individuals and one-third for firms.

---

36Total savings (cash and non cash) in rural areas were estimated at US$500 million: 90 percent of households surveyed had financial savings and non-financial savings (cattle and precious stones). Cash accounted for 10 percent of savings on average with only 1 percent (i.e., US$5 million) mobilized in bank accounts. (in Microfinance in rural Lao PDR, A National Profile. UNDP, 1997.)
firms. To be noted that 80 percent of cash is still deposited with SOCBs. This evidences very clearly that people although they are defiant of the banking system prefer Government owned banks. Expectations are that the Government fully and unconditionally guaranties deposits as both the owner and the responsible supervisory authority.

141. **Historical reasons**, such as war or more recently the credit cooperatives problems in the early nineties, may explain some behaviors such as the preference for stocking one’s mattress with cash rather than opening an account in a bank.

142. **But there are also policy choices that have affected incentives and the saving rate, hence amounts mobilized.** The limited flexibility in the lending interest rates does not allow banks to adjust their nominal rates on deposits to take into account inflation, without creating negative spreads. For example, real rates on deposits were negative when inflation ran at high levels. However, some studies have shown that in low-income countries, the saving rate did not respond to changes in the real interest rates as much as they do in middle or upper income countries. Nevertheless, such a situation offers little incentive for households to convert livestock and precious metal into cash and to deposit it in bank accounts.

143. **Lower income** reduces the saving capacity as the share of subsistence in total consumption rises. This is the result of a high public deficit that has created a high level and high volatility of inflation which in turn has destabilized the economy.

144. Finally, **recent inflation levels** discouraged monetary savings as people preferred—very rationally—to repair a house or buy precious metals, i.e. to switch from Kip to a safer store of value.

### 2. Banks’ Resources

145. Deposits constituted the main resource of Lao commercial banks, accounting for about 60 percent of total liabilities. On December 31, 1999 total deposit amounted to Kip 1.9 trillion that is equivalent to US$247 million of which less than 20 percent were Kip denominated deposits (see Table 5). Deposits represented about 15 percent of GDP in 1999 (Monetary Survey). This is small compared to other countries like China where deposits as a percentage of GDP was 80 percent in 1995. SOCBs are entrusted with 80 percent of deposits in the banks. Between December 1997 and September 1999, Kip denominated deposits decreased in real deflated terms by approximately 40 percent while US dollar-denominated deposits more than doubled.

---

Table 5.
Composition of Banks’ Deposits

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th></th>
<th>1999</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Kip billion</td>
<td>As %</td>
<td>Kip billion</td>
<td>as %</td>
</tr>
<tr>
<td>Total Deposit</td>
<td>1,003</td>
<td>100.0</td>
<td>1,880</td>
<td>100.0</td>
</tr>
<tr>
<td>Current deposit</td>
<td>106</td>
<td>10.6</td>
<td>141</td>
<td>7.5</td>
</tr>
<tr>
<td>Time and Savings</td>
<td>116</td>
<td>11.6</td>
<td>98</td>
<td>5.2</td>
</tr>
<tr>
<td>Foreign currency</td>
<td>581</td>
<td>57.9</td>
<td>1,227</td>
<td>65.3</td>
</tr>
<tr>
<td>Govt. and BOL deposit</td>
<td>103</td>
<td>10.3</td>
<td>247</td>
<td>13.1</td>
</tr>
<tr>
<td>Deposits from Intern. Institutions</td>
<td>51</td>
<td>5.1</td>
<td>82</td>
<td>4.4</td>
</tr>
<tr>
<td>Other</td>
<td>45</td>
<td>4.5</td>
<td>85</td>
<td>4.5</td>
</tr>
</tbody>
</table>

146. Borrowings from BOL was the second main liability of the banking system accounting for 10 percent of total balance sheet. BOL provided selectively resources to the banking industry. At the end of December 31 1999, the total debt of the banking system to the Monetary Authority amounted to almost Kip 314 billion of which Kip 230 billion was lent to BCEL and Kip 66 billion to Agriculture Promotion Bank. This illustrates BOL direct support to public banks.

147. Capital was the third source of funds: on a consolidated basis, reported capital was 15 percent of total consolidated balance sheet, much overestimated due to inadequate provisioning.

148. On the assumption that about 5 percent of the population (i.e., 250,000 people) have a bank account, the average balance would stand at approximately US$500 equivalent, representing about 3.5 times the minimum yearly salary. In the event of a banking crisis, it would be difficult for the Government not to reimburse individual depositors, who account for half of total deposits, to a large extent. The average balance represents more or less 2 years salary in the public service.

C. CAPITAL ALLOCATION, CREDIT RISK AND BANKS’ CAPITAL

149. It is difficult and costly to evaluate firms, managers, projects and market conditions. Financial arrangements arise to reduce these information and transaction costs and ensure that capital will flow to its highest value use. How well does the Lao financial system acquire and process information becomes a legitimate question to assess the level of its development. In the case of Lao PDR, the limited capital is unfortunately not allocated to its best use. This misallocation has resulted in an insolvent banking system as banks lent foreign currencies to borrowers without foreign exchange revenues and SOEs have benefited from the majority of funds and defaulted on almost all their obligations.

---

38 Minimum salary was 93,600 kip per month as from July 2000, as per Notice 1565/MLSW dated May 1 2000. Exchange rate as July 1 2000 was 7,790 Kip per 1 US$. 
1. Capital Allocation and Policy Lending

150. There are three reasons why the financial system cannot perform well this function. First, there is a critical lack of skilled human resources. Neither BOL, which should provide global economic analysis, nor the SOCBs which allocate two thirds of capital have sufficient skilled staffs. The SOCBs for instance, do not have a Research and Development Unit helping in decision making and evaluating business opportunities and credit officers lack the skills in analyzing credit risk, project risk, market risk and foreign currency risk. According to external auditors, the SOCBs do not have formal lending policies, credit limits and do not use a standard credit appraisal document. An external legal opinion on the loan contract is not sought. SOCBs do not have a policy of when to take legal action over a particular borrower nor a policy to obtain regular financial statements from all of their borrowers. Site visit reports are not prepared. Credit files are not properly kept. Internal auditors do not carry out a regular review of bank’s loans, to ensure that they comply with internal and the BOL’s regulations. The classification of loans is not regularly carried out. These are significant deficiencies: improving the “Loan Cycle” is a long term endeavor. But this task has started. Nevertheless, connected lending will remain an area of great concern for some time.

151. Second, price signals are distorted hence capital cannot flow to its highest use. In theory, commercial banks are free to set their interest rates on loans since the elimination of the guideline on maximum lending rates in June 1995 and there is no official restriction on the maximum spread. In practice, however, observations tend to show that SOCBs behave in identical ways by not pricing loans according to risks and maturity but rather by seeking compliance with the government policies currently aiming at developing agriculture, industry and manufacturing sectors (see Table 6). The Lao authorities have nominally deregulated interest rate policy but the current interest rate structure suggests that the SOCBs’ settlements of interest rates are unambiguously guided by the government authority.

Table 6.
Lending Interest Rates of SOCBs (end of February 1999)

<table>
<thead>
<tr>
<th></th>
<th>Short term</th>
<th>Medium term</th>
<th>Long term</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Kip Accounts</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture &amp; forestry</td>
<td>22-27</td>
<td>21-28</td>
<td>22-30</td>
</tr>
<tr>
<td>Industry &amp; handicrafts</td>
<td>30-30</td>
<td>31-32</td>
<td>32-34</td>
</tr>
<tr>
<td>Construction</td>
<td>30-30</td>
<td>30-32</td>
<td>31-34</td>
</tr>
<tr>
<td>Trade, service &amp; transp</td>
<td>32-32</td>
<td>33-34</td>
<td>34-36</td>
</tr>
<tr>
<td><strong>Baht Accounts</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture &amp; forestry</td>
<td>12-12</td>
<td>14-14</td>
<td>15-15</td>
</tr>
<tr>
<td>Industry &amp; handicrafts</td>
<td>15-15</td>
<td>16-16</td>
<td>16-17</td>
</tr>
<tr>
<td>Construction</td>
<td>15-16</td>
<td>16-16</td>
<td>17-17</td>
</tr>
<tr>
<td>Trade, service &amp; transp</td>
<td>16-16</td>
<td>16-17</td>
<td>17-18</td>
</tr>
<tr>
<td><strong>US dollar Accounts</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture &amp; forestry</td>
<td>10-11</td>
<td>11-12</td>
<td>13-15</td>
</tr>
<tr>
<td>Industry &amp; handicrafts</td>
<td>11-12</td>
<td>12-13</td>
<td>14-17</td>
</tr>
<tr>
<td>Construction</td>
<td>12-12</td>
<td>13-14</td>
<td>14-17</td>
</tr>
<tr>
<td>Trade, service &amp; transp</td>
<td>12-13</td>
<td>14-14</td>
<td>15-17</td>
</tr>
</tbody>
</table>
152. Third, credit is largely allocated based on policy decisions. Economic policies are translated by BOL into credit policies, i.e. a credit growth rate for the whole banking system with priority sectors. The SOCBs’ management then prepare and propose their annual plan to their board of directors. As of December 1999, the estimated amount of policy-based lending was approximately Kip 400 billion that is about 40 percent of total loans in the banking system (Kip 1 trillion). This is in line with the monetary survey and does not include BOL lending to the Government which in fact runs a current balance surplus and borrows essentially to finance capital investments. Besides contributing to creating inflation and distortions, massive resources are allocated less efficiently as public sector investment efficiency is decreasing, see Chapter I.

153. In China for instance, where the NPLs of state banks is also a significant problem, it was shown that the bad debt problem was the mainly result of policy/directed lending to loss-making state-owned enterprises. SOEs make losses in part because carry excessive welfare burdens (such as providing almost free housing to employees) and banks make losses because they have to lend to loss making enterprises which are unlikely to repay. In this context, the financial situation of banks and SOEs are highly interdependent.

154. Policy lending is a complex subject. Policy lending exists in many countries and is often confused with directed lending. Directed lending can be defined as a credit activity on a case by case basis under pressure of Authorities; it leads easily to non-commercial lending and often to actual subsidies in disguise, a major cause of NPLs. True policy lending is a credit activity under a well articulated policy with clear objectives, identified costs and measurable results. The policy can affect access to credit, the price of credit or both. As a principle, it is essential that institutions which make the credit decisions are held accountable and institutions who are held accountable do have the proper power to reject non-viable projects and/or excessive risks.

155. Lessons from history point to some key ingredients to avoid major pitfalls inherent to policy lending: macro-economic stability; existence of competitive market environment, with private enterprises as recipients; good capacity in the government to analyze and establish policies, and measure results; substantive dialogue between government and private sector; export orientation policies as it forces domestic firms to be internationally competitive. But even when these conditions are met, policy lending has costs, as evidenced in the cases of Japan and Korea: inflationary pressures, overcapacity in selected sectors, and governance problems. Furthermore, policy lending weakened the banking system and retarded the development of capital markets.

2. Banks’ Assets

156. Lao banks are not lending much. This is illustrated by the fact that as of September 1999, loans constituted the main item in the consolidated balance sheet but only accounting for only 33

---

39 Up to recently, the board of director was appointed by BOL but now MOF is responsible. This change is not likely to produce a behavioral change with respect to policy lending.
40 Assumptions are: loans to SOEs are policy based i.e. 2/3 of BCEL’s and 50 percent of Lane Xang bank’s, Lao May bank’s and Agricultural Promotion Bank’s portfolios
percent of total banks’ assets while the loan-to-deposit ratio stood at a low 50 percent. Should non-performing loans be *adequately* provisioned then the share of loans-to-total assets would be much smaller (see Table 7). The share of loans to the private sector was about 53 percent of total loans while the share of loans to the public sector\(^{42}\) was 47 percent.

157. At year end 1999, 75 percent of bank loans were denominated in foreign currency. Between December 1997 and September 1999, Kip denominated loans decreased by 23 percent in US dollar equivalent or by 56 percent in deflated real Kip, while dollar denominated loans doubled. The supply of Kip denominated loans decreased as banks were reluctant to lend at negative real interest rates. The demand for Kip denominated loans also decreased as borrowers preferred to borrow in foreign currency to lower the nominal cost of the loan forgetting to factor in the foreign exchange risk.

158. This situation is at the origin of the existence of many non-performing loans. Banks granted credit in foreign currencies even when borrowers did not have revenues in foreign exchange. As the Kip depreciated, borrowers needed more and more Kip to repay the loan. Borrowers first increased the prices of their goods and services (hence fueling inflation) until it was not possible anymore and then they defaulted on their loan. The loan became non performing.

<table>
<thead>
<tr>
<th>Name of Institution</th>
<th>Outstanding loans (billion Kip)</th>
<th>Market share to total of loan (%)</th>
<th>Estimated non-performing As % of outstanding loans by BOL</th>
<th>1999 portfolio review</th>
</tr>
</thead>
<tbody>
<tr>
<td>BCEL bank</td>
<td>392</td>
<td>40</td>
<td>30</td>
<td>88</td>
</tr>
<tr>
<td>Lao May Bank ltd.</td>
<td>110</td>
<td>11</td>
<td>29</td>
<td>84</td>
</tr>
<tr>
<td>Lane Xang Bank ltd.</td>
<td>70</td>
<td>7</td>
<td>7</td>
<td>47</td>
</tr>
<tr>
<td>Joint Development Bank</td>
<td>84</td>
<td>9</td>
<td>83</td>
<td>NA</td>
</tr>
<tr>
<td>Other banks</td>
<td>331</td>
<td>34</td>
<td>16.5</td>
<td>NA</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>987</strong></td>
<td><strong>100</strong></td>
<td><strong>60% (*)</strong></td>
<td></td>
</tr>
</tbody>
</table>

(*) Weighted average of banking system.

159. Nevertheless, policy based lending appear to be responsible to a great extent for the current situation characterized by a high level of NPLs. With the assumption that SOCBs’ loans to the state sector are directed, an analysis of SOCBs’ loan portfolio shows that about 80 percent of loans to the state sector are non-performing while “only” 58 percent of loans to the private sector are non performing.

\(^{42}\)Public sector comprises of Government entities at the national, provincial and municipal levels, companies that are state-owned, joint ventures with the Government and state-connected enterprises (including those closely identified with the Government and undertaking projects for the Government). There appears to be some inconsistencies between the banking accounting procedures and the above definition of public sector enterprises.
160. As of September 1999, foreign assets deposited outside the country in “nostro accounts” constituted the second main item (26 percent of total assets) and reserves deposited at BOL the third main item (13 percent of total assets) while securities issued by the Government accounted for 2 percent of total assets. This leads to the conclusion that probably most of the banks’ revenues are derived from investing their liquid assets abroad.

3. Credit Risk and Banks’ Capital: Evidence of a Crisis

161. The Lao banking system appears to be in crisis as more than two third of the system is technically insolvent. There is a need for approximately Kip 380 billion (US$50 million) of capital because in the case of a small and concentrated economy such as Lao PDR the capital adequacy ratio should be at least around 12 percent to ensure that the banking system would not be wiped out in the event of a sharp economic down-turn.

162. An audit of 1997 accounts of the seven former SOCBs (prior to consolidation), conducted by KPMG (Australia) in accordance with international accounting standards, found all of them to be insolvent. The non-performing loans (NPLs) of the seven banks ranged from 25 to 70 percent of total outstanding loans as at the end of December 1997. Provisions recommended by KPMG amounted to Kip 103 billion (US$50 million) or 70 percent of their loan portfolios. Based on 1998 accounts, a portfolio review was performed in mid-1999. The estimated provisions for the three SOCBs amounted to Kip 229 billion (equivalent to US$53.6 million, at the official exchange rate of Kip 4,275 per US dollar at the end of 1998), hence confirming the previous assessment. This amount was 63 percent of the aggregate loans of the SOCBs. The actual provisions made by the SOCBs amounted only to Kip 4.9 billion, i.e., only 2 percent of required provisions. It should be noted that the capital deficiency is increasing as the Kip devalues against the US dollar, as SOCBs largely conduct their business in US dollar with a Kip capital base.

163. As of June 30 1999, the negative net worth of SOCBs was estimated at Kip 254 billion or US$33.4 million equivalent. Should the Government decide that SOCBs must comply with Lao capital adequacy norms (8 percent), then the injection of Kip 307 billion (US$40.4 million) of capital would be needed. To achieve 12 percent capital adequacy, the recapitalization requirement would be about Kip 333 billion (US$43.8 million).

164. The seven SOCBs that were created from branches of the former State Bank of Lao after the two-tier banking system was established in March 1988 did not get the right start. They were not properly capitalized at the outset and carried loans to SOEs and cooperatives from the planned economy period. Most of these loans were NPLs. In 1994, the Government recapitalized the SOCBs: (i) cash injection of Kip 4 billion in March 1994, (ii) issuance of 14 billion Kip in treasury bonds in late 1994, and (iii) removal of NPLs from SOCBs balance sheet. But without a sustained program for improving banking and borrowing practices, in 1997

---

43Assumptions for these calculations are the following: (a) loan-loss provisions amount to 60 percent for SOCBs’ loan portfolios, and (b) SOCBs’ risk weighted assets amount to 50 percent of total assets. Exchange rates used are: US$1 for 7,600 Kip; 1 Thai Bath for 197 Kip (November 1999).

44The Treasury bonds exchanged for bad loans are long term bonds, ranging from 1 to 10 years, issued by the government with an average rate of 15-18 percent. These bonds are redeemable up to year 2004.
all SOCBs were found insolvent again. A detailed analysis of the current ten largest NPLs shows approval dates ranging from 1993 to 1999.

165. As for the whole banking system, at the end of 1999, approximately 60 percent of all loans outstanding were non-performing and the estimated total negative net worth Kip–300 billion\(^{45}\). In order to comply with an 8 percent (12 percent) capital adequacy ratio, a capital increase of Kip 350 billion (Kip 380 billion) is needed. Country comparisons in Table 8 show that, in relative terms, Lao PDR’s situation is challenging.

### Table 8. Credit risks, Non-performing Loans and Capital Adequacy

<table>
<thead>
<tr>
<th>Country</th>
<th>Non-performing loans/total loans (%)</th>
<th>Loan loss reserves/total loans (%)</th>
<th>Capital adequacy ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lao PDR **</td>
<td>60</td>
<td>4</td>
<td>-5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>34</td>
<td>6</td>
<td>-15</td>
</tr>
<tr>
<td>Thailand</td>
<td>30</td>
<td>4</td>
<td>-4.5</td>
</tr>
<tr>
<td>China</td>
<td>25</td>
<td>1</td>
<td>3-5*</td>
</tr>
<tr>
<td>Vietnam*</td>
<td>24</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>Malaysia</td>
<td>18</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Korea</td>
<td>16</td>
<td>2</td>
<td>-1</td>
</tr>
<tr>
<td>Japan</td>
<td>6</td>
<td>4</td>
<td>9</td>
</tr>
<tr>
<td>United States</td>
<td>2</td>
<td>3</td>
<td>13</td>
</tr>
</tbody>
</table>

* Total numbers of NPLs are official estimates. Data for Vietnam are as of October 1998.

** September 1999. Capital Adequacy ratio for SOCBs is approximately –20%.

*Note:* Data on NPLs is not readily available and official figures differ much from market estimates. Furthermore, NPLs often have a country specific definition. For these reasons numbers are low-end estimates and country comparisons are difficult.

166. The Lao banking system appears to be in crisis as four major institutions holding two-third of the banking assets are insolvent. In addition, they hold almost 80 percent of total deposits. There is a need for approximately US$50 million of capital (including US$44 million for the SOCBs) because in the case of a small and concentrated economy such as Lao PDR the capital adequacy ratio should be at least around 12 percent to ensure that the banking system would not be wiped out after the first economic down turn. Strict compliance with Lao regulation (8 percent) would still require US$46 million.

167. Unfortunately, it is unlikely that Thai banks, which are the dominant foreign partners can help. Except for one bank, they all face a substantial capital deficit at home in the aggregate amount of about US$12 billion, according to a note by BankWatch dated November 1999.

168. However, the Lao banking system was liquid as banks could have faced a 30 to 50 percent deposits withdrawal. At year end 1999, SOCBs were liquid: when liquid assets (cash

\(^{45}\)For non SOCBs: we assume that NPLs reported by management are underestimated by 25 percent and that 80 percent of NPLs are actual losses.
reserves and foreign assets held in *nastro* accounts) are compared to deposits from customers (excluding Government deposits), the coverage ratios (liquid assets-to-deposits) varied between 45 percent and 90 percent. But the liquidity position can change quickly, and the problems keep growing, as liabilities increase and revenues do not and losses are financed by deposits.

4. Implications

169. Crisis must be avoided and the system must be recapitalized. But recapitalization should be the last phase of a long and painful process to avoid recurrence. Three critical guiding principles are highlighted. First, in the Lao case, all the lessons learnt from the 1994 failed recapitalization must be clearly articulated and integrated in any plan. Second, banks --which will receive public support-- must be able to generate a new flow of quality loans in the future. Third, banks must have quality borrowers. Therefore, reforming policy lending and SOEs is as important and must take place simultaneously: it is the other side of the same problem.

170. Banking crisis are generally extremely costly and the overall cost can spiral out of control if not dealt with in a decisive and rapid manner. Recapitalization of banks is generally the most important outlay. (See Figure 13.)

171. In the case of Lao PDR, the current *maximum* estimate (1999) for recapitalization is about Kip 380 billion (i.e. US$50 million\(^{46}\)) for the total banking system. We will assume that the current *realistic* estimate (after balance sheet clean up as mentioned earlier) is 10 percent less than the current maximum amount,\(^{47}\) i.e. about 340 billion. With the assumption that Government swaps all remaining NPLs with special T-bonds for that amount, the outlays would

---

\(^{46}\)Exchange rate: US$1 = 7,500 Kip (December 1999)

\(^{47}\)In the case of Mongolia, the banks were able to reduce their liabilities by 10 percent by offsetting some NPLs with deposits.
amount to more than 3.9 percent of GDP. The initial\textsuperscript{48} debt service of these special T-bonds would now amount to approximately 10.6 percent of total government revenues the first year\textsuperscript{49} thanks to an improved macroeconomic situation. This estimate does not include other costs such as the cost of potential retrenchment and social plans. The fiscal cost of the recapitalization appears to be a heavy burden and can derail any budget and development plan. (To be noted that these estimates are based on 1999 figures and would need to be updated.)

172. As a comparison, when Indonesia unveiled its 2000 budget in January, the hefty burden of bank restructuring became known. The cost to the budget of interest payments on bonds issued to recapitalize banks are set to absorb 23 percent of the budget total expenditures.

173. The sheer magnitude of the costs makes it difficult for governments to actually recognize banking crisis. However, it is the IFI’s experience that, waiting only adds to the final bill because underlying structural issues are not addressed and problems remain and worsen.

**D. OTHER FUNCTIONS OF THE FINANCIAL SYSTEM**

1. **Ex-post Corporate Control**

174. Besides reducing the costs of acquiring information ex-ante, financial contracts, market and intermediaries may arise to mitigate the costs of monitoring firm managers and exerting control \textit{ex-post}, i.e., after financing the activity. Suppliers of finance to corporations rely on corporate governance to ensure a return.

175. Corporate governance is concerned with the systems of law, regulation, and practice which will promote enterprise and ensure accountability. From a \textit{corporation’s perspective}, the emerging consensus is that corporate governance is about maximizing value \textit{subject} to meeting the corporation’s financial and other legal and contractual obligations. This inclusive definition stresses the need for boards of directors to balance the interests of shareholders with those of other stakeholders—employees, customers, suppliers, investors, communities—in order to achieve long-term sustained value.

176. From a \textit{public policy perspective}, corporate governance is about nurturing enterprises while ensuring accountability in the exercise of power and patronage by them. The role of public policy is to provide enterprises with the incentives and discipline to minimize the divergence between private and social returns and to protect the interests of stakeholders.

177. These two definitions - from public and private perspectives- provide a framework for corporate governance. This framework reflects this interplay between \textit{internal incentives} (which define the relationship among the key players in the corporation i.e. shareholders, Board of Directors, Managers…) and \textit{external forces} (notably policy, legal, regulatory, and market) that govern the behavior and performance of the enterprise.

\textsuperscript{48}The assumption is that these are long term bonds and that rates are reset every year. Average initial yearly interest rate: 30 percent; no principal reimbursement

178. In Lao PDR, corporate governance is weak for three main reasons. First, the legal and regulatory framework is weak in certain critical areas such as auditing or when it exists, it is not implemented and enforced for a number of reasons as seen earlier. Second, institutional weaknesses at the level of Ministry of Finance combined with a preference for little disclosure does not create the right internal incentives for the managers of the State-Owned Enterprises. It is recalled that that there are still 42 SOEs in Lao PDR\(^{50}\) and that their financial performance is not centralized and monitored. Third, the financial sector is weak lacking adequate capacity and as such is unable to fulfill this important function.

179. In such an environment, banks should be even more careful. They have little alternative but to rely on the quality of their work (initial analysis) to ensure that necessary incentives and covenants are in place to ensure adequate behavior and reimbursement of the loan. This also requires adequate supervision. But according to donors financed external audit reports, SOCBs do not have a policy to obtain regular financial statements from all of their borrowers. Site visit reports are not prepared. Credit files are not properly kept.

2. Facilitation of Transactions

180. Greater specialization generally boost innovation and growth. But production technologies with more specialization involve more transactions. Transaction costs become important. Therefore, if the financial system can lower trading costs it directly promotes specialization and growth. By reducing payment costs via an efficient payment system, the financial system contributes directly to growth. In Lao PDR few payments are handled by the financial system and as a result it cannot contribute much. The main reasons appear to be the little use of checks and other payment instruments and the fact that BOL clears few transactions denominated in foreign currencies. In Lao PDR, an efficient payment system would allow an increased usage of the current limited M2, without creating inflation and instability and provide finality of transactions thus ensuring that no exposure risk is being built in the system.

181. The payment system is at an early stage of development. Domestic payments are still dominated by the use of cash in which the US Dollar and Thai Bath circulate widely along with the Lao Kip. This reliance on cash will become more expensive and inefficient as the volume of business transactions increase. Checks remains little used and is confined almost exclusively to banks and larger enterprises. The check clearing is conducted by the Bank Operation Department, at the BOL, on a daily basis from Monday to Friday. At 3:00 pm, the representatives of each commercial banks would bring their checks and, manually, offset their assets and liabilities with each other. The average value of checks was more than US$5,000 equivalent reflecting the use as a mean to settle large value transactions. The process takes two days in Vientiane to settle and up to seven days for non-local checks. The use of checks is stagnating or decreasing: the number of check cleared by the house has decreased from 25,257 checks in 1997 to 24,454 checks in 1998. Promissory notes are being promoted. The fact that the forms of checks are not standard and not machine readable may become an impediment to the development of the use of checks in the future.

182. Credit cards are normally used by foreigners to settle hotel bills, pay visa fees, and purchase airplane tickets. All external fund transfers are carried out by telex through the BCEL and its foreign correspondent banks for the SOCBs, or through Bangkok for Thai bank branches.

183. There is little activity in foreign currency transactions because the list of permissible transactions in foreign currency is short. Transactions are cleared and settled directly over-the-counter or bilaterally between banks as BOL does not provide separate clearing sessions for US dollar or Thai Bath. In the Lao context where the economy is 80 percent dollarized, the question whether BOL should clear all foreign exchange transactions should be asked.

The Payment System Supervision Function

184. Article 44 of BOL Law, recently amended, provides that “The Bank of Lao PDR shall establish a mechanism of payment for the purpose of providing commercial banks and financial institutes under its management with instruments for payment and the widespread use of checks and other instruments for payment.”

185. The legal foundation for the payment system is the Decree on Check No. 175/PM adopted by the Prime Minister in October 1996. In January 1997, the BOL published a manual describing how checks are to be used. More recently, the Decree on Bill of Exchange and Promissory Notes was enacted in December 1998.

186. According to IMF/MAE, the Clearing House Agreement is out of date binding only those banks who have signed it i.e. SOCBs. A major improvement would consist in providing explicit arrangements for resolving conditions of the failure of a participant to settle, i.e., early unwinding and later loss sharing.

3. Risk Management (facilitate trading, hedging and pooling of risks)

187. Generally, high return projects require long-run commitment of capital, but savers do not want to relinquish control over their savings for long periods. By augmenting the liquidity of long term investments, the financial system makes high return projects more likely to occur.

188. Risk diversification services which should be provided through a variety of instruments, institutions and markets are not provided by the Lao financial system. Savings can only be invested in (a) banks (generally weak, small when not a foreign branch, opaque because there is no disclosure and not well supervised) or directly in (b) projects (bigger amounts and long term locked in). Liquid government investment instruments are not readily available nor investment vehicles to allow some pooling and diversification of risks.

189. When competition increases, providers of financial services become more demand driven to survive and as a result, financial services including risk management, improve. Ensuring the emergence of non-bank financial institutions (NBFIs) is a way to allow improvements without weakening the banking sector: NBFIs increase the market for financial services rather than cannibalizing existing markets by using different lending methodologies.

51 Steps to Banking Soundness, November 1998.
CHAPTER V. SECTORAL ANALYSIS

190. In Chapter V, we turn our attention to two important economic sectors to the Lao economy: the agricultural sector and the private sector. While the agricultural sector is currently pulling the economy, it will probably never generate the necessary growth rates to significantly reduce poverty. The private sector should be considered as a potential future engine of growth and development. After a description of their main characteristics, we analyze how they are financed.

A. AGRICULTURAL SECTOR

191. The nature of the needs for financial services arises the major constraints that Lao farmers are facing. There are needs for long term capital for infrastructure but also for financing the production cycle. The supply of financial services has remained low. In some cases there are special arrangements, otherwise besides the Agricultural Promotion Bank and informal lenders, there are little choices as there are only few microfinance institutions.

1. Agriculture: Importance and Issues for the Main Products

192. Agriculture accounts for over 50 percent of GDP and provides for 85-90 percent of employment. While the economy grew at an average of 7.6 percent from 1989 to 1997, agricultural output achieved an average growth rate of 5.4 percent. In 1998, GDP grew at 4 percent and the agriculture sector at 3 percent, but in 1999 GDP grew at over 7 percent and agriculture sector at about 8 percent. (See Table 9.)

Table 9.
Contribution of the Agricultural Sector

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture prod. real growth (%)</td>
<td>5</td>
<td>9</td>
<td>3</td>
<td>2</td>
<td>7</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Agriculture sector as % of GDP</td>
<td>63</td>
<td>61</td>
<td>54</td>
<td>54</td>
<td>53</td>
<td>53</td>
<td>52</td>
</tr>
<tr>
<td>Crops</td>
<td>36</td>
<td>37</td>
<td>27</td>
<td>26</td>
<td>27</td>
<td>28</td>
<td>26</td>
</tr>
<tr>
<td>Livestock/fishery</td>
<td>21</td>
<td>21</td>
<td>21</td>
<td>21</td>
<td>20</td>
<td>20</td>
<td>21</td>
</tr>
<tr>
<td>Forestry</td>
<td>6</td>
<td>3</td>
<td>6</td>
<td>7</td>
<td>6</td>
<td>5</td>
<td>5</td>
</tr>
</tbody>
</table>


193. Agriculture in Lao PDR is generally characterized as subsistence farming, using little commercially procured inputs. The agricultural economy is dominated by rice, the major crop grown mainly for subsistence. Based on the census conducted recently, in 1999, rice accounted for nearly 80 percent of crop output. Paddy is planted on over 735,000 hectares, or about 84 percent of total cropped area. Other temporary crop include tobacco, groundnut and sugarcane. Coffee is the most important permanent crop with 41,000 hectares and US$48 million of export earnings in 1998 (out of US$172 agricultural exports including wood products). Livestock production, particularly buffalo (48 percent of holdings), cattle (31 percent) and poultry (73 percent) are a major source of cash income. Timber and wood products also earn valuable foreign exchange for the country.
194. Land is owned and administered by the State but is leased to farmers for long-term use, a right which can be inherited. Almost 97 percent of agricultural land is operated under “owner-like” tenure. Agriculture production is in a private sector endeavor. The average land holding is small; in 1999, the average size was 1.62 hectares.

195. The Government articulated its strategic vision for the agricultural sector\textsuperscript{52}. The strategic vision reckons the dual agricultural economies in Lao PDR: the flat lands along the Mekong corridor and the slopping lands. \textit{In the flatlands}, market forces are starting to drive the production. Households are consuming part of their farm production and marketing the remaining part. The strategy is to maintain and accelerate the pace of agricultural diversification and intensification with increased productivity, improved value added processing and expanded marketing and sales.

196. \textit{The slopping lands} agriculture is a subsistence agriculture where farm households are locked in a poverty trap created by the lack of access to market, technology and capital. The multi-faceted strategy envisioned, integrate soil erosion and socioeconomic parameters. The strategy is community focused with small scale irrigation, limited diversification and improvement of access to land, market and capital.

197. In both cases, the access to adequate financial services is part of the strategy. More specifically the “Flatland Strategic Initiatives” include (a) \textit{strengthening and expanding rural credit facilities through free competition and market determined interest rates and (b) supporting and strengthening rural and agribusiness lending by SOCBs and private commercial banks}; while the “Slopping Land Strategic Initiatives” include (c) \textit{“rural saving mobilization and micro-credit extension,”} (d) \textit{“competitive rural finance system development with market determined interest rates in most areas and subsidized rates in some areas to promote technology adoption among the poorest socioeconomic strata,”} and (e) \textit{“strengthening the capacity and legal framework of SOCBs in commercial and banking transactions.”} We will now review the financial services needed and supplied in the rural areas.

198. Annex 6 reviews three main agricultural sub-sectors: rice, coffee and livestock in greater detail. Despite its relative importance (50 percent of total land is covered by primary forest), we do not touch upon the forestry sub-sector because financing for that activity does not appear to be a problem.

2. Financial Services

\textbf{Demand}

199. Savings are generally kept in the form of crops, livestock, and precious metals (gold and jewelry). Cash savings are kept at home due primarily to lack of access to the formal banking

\textsuperscript{52} The Government’s Strategic Vision for the Agricultural Sector. Ministry of Agriculture and Forestry, December 1999.
system. At the time of the survey of rural household conducted in 1996, only about $37 million of cash holdings and $272 million of nonfinancial savings in livestock were estimated.

200. Only about 11 percent of rural households carry debts and about 1 percent hold bank deposits. Around 80 percent of rural small and medium enterprises never used loans, approximately 15 percent borrowed from family members or friends and 3 percent borrowed from money lenders.

201. Extension of agricultural credit has been more supply-driven, rather than demand-driven. Agricultural credit is characterized by heavy subsidies, directed lending to support government projects, government intervention in providing agricultural credit and in fixing interest rates.

202. The nature of the needs for financial services arises the major constraints that Lao farmers are facing. The need for savings services has been evidenced in the national survey. Short term credit products include essentially small working capital loans to finance the production cycle; for instance, coffee lacks inputs as little chemical fertilizers and agricultural chemicals are used. Demand for emergency loans (funerals, wedding, sickness) is also significant. Longer term loans (more than one year) to finance investments in micro-enterprises are also needed. Long term capital needs for infrastructure remain with the Government. Rice production and cattle raising suffer from the lack of large investments: in the case of rice, irrigation and in the case of cattle growing, slaughtering facilities, cold chain etc…

203. As secondary constraints, rice production also suffers from little mechanization as there is a shortage of labor at select periods. Harvesting and threshing and winnowing are undertaken manually by family or labor exchange with neighbors and relatives at no cash exchange. Demand for credit is limited by the fact that barter trade is widely practiced; for example, villagers often pay in rice when hiring a buffalo.

Supply

204. Despite above needs, the supply of financial services has remained low. In some cases there are special arrangements, otherwise besides the Agricultural Promotion Bank (APB)—the Government owned policy bank—and informal lenders, there are little choices as there are only few microfinance institutions (MFIs). Limited data on commodities’ prices in time and space are an obstacle to adequate financing.

205. Special arrangements. In the case of coffee, distribution and export is controlled by the “Lao Coffee Exporters Association” set up by the Ministry of Trade. Members of the Association must possess a license to trade coffee beans and supply loans to the farmers who grow coffee. However, it is not certain that traders lend to growers consistently. Nevertheless, financing coffee growers is probably the easiest as prices are known and traders are licensed.

54Up to as late as 1987, government officials were paid in kind for 90 percent of their salaries with only 10 percent of salary paid in cash.
206. **Money lenders.** The role of money lenders in both urban and rural areas is estimated to be quite important: approximately 50 percent of rural villages appear to have access to money lender services. Most professional money lenders operate close to the markets and lend for quick turnover activities. According to professional observation, rates have been stable for the last few years ranging from 10 and 30 percent per month with lower interest rates in urban areas due to competition. Supplier credit for agricultural inputs is rare. Some foreign suppliers across the Mekong River accept precious metals as collateral for merchandise purchases.

207. Currently, the **Agricultural Promotion Bank** (APB) is the only institution providing financial services of any significance to the rural households from the formal sector. APB was established in June 1993, by consolidating the agriculture loan portfolios and staff of the three SOCBs providing credit to agriculture. APB finances the production cycle and investments. (Please see Annex 4 for a financial analysis of APB).

208. APB has 490 employees and is being managed by the Board of Directors consisting of members from the Ministries of Finance, Commerce, and Agriculture and Forestry. APB has three branches, 14 service units and 47 sub-service units located in 17 provinces and Vientiane Municipality. At the district level, APB has 47 sub-service units. In January 2002, out of 144 districts, APB covered 133 and has no operations in 11. APB had little deposit: Kip 17.7 billion in 1998 from about 80,000 depositors. Its number of borrowers totaled 35,192 for a total loan portfolio of Kip 47.0 billion in 1998. APB lends directly to rural households and farmers with both loans to individuals and groups.

209. APB channels subsidies to the agricultural sector through soft loans. Interest rates charged for paddy cultivation, irrigation, livestock and food production in 1999 varied between 10 to 12 percent while lending rates for non-targeted sectors and services were 30 to 32 percent. About 60 percent of APB’s funding comes from the Ministry of Finance at interest rates between 5 to 7 percent while deposits at 22 to 24 percent account for the balance.\(^5\)

210. APB has multiple objectives which are difficult to achieve simultaneously. APB is not only a bank, it is also an agriculture promoting agency and act as a “super-coop” for agricultural inputs and equipment by importing and providing fertilizers, hand tractors and equipment to borrowers or rather lending in kind. For a fee, APB also sells bilateral donations such as fertilizers or rural equipment to the farmers, on behalf of the Government. Consequently APB

---

\(^5\)Until June 1998, the Government has insisted that all loans to farmers from government funds, including donor funds, be on-lent at 7 to 10 percent interest rate. Recent data from the APB show interest rates at 26 percent when inflation ran at 100 percent.
remains a weak institution as its staff is not adequately trained to (a) conduct banking business, (b) promote Government policies, and (c) import agricultural inputs. As a result its financial situation is weak, as evidenced by a capital adequacy ratio of 1.7 percent and the institution is not sustainable.

Table 10: Financial Situation of APB
(as of September 30, 1999)
(in billions of Kip)

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>5</td>
<td>Deposits</td>
<td>42</td>
</tr>
<tr>
<td>Deposits</td>
<td>12</td>
<td>Borrowings</td>
<td>71</td>
</tr>
<tr>
<td>Credits</td>
<td>87</td>
<td>(incl. from BOL</td>
<td>64</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>2</td>
<td>Others</td>
<td>21</td>
</tr>
<tr>
<td>Others</td>
<td>37</td>
<td>Capital</td>
<td>0.9</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td><strong>144</strong></td>
<td><strong>Liabilities</strong></td>
<td><strong>144</strong></td>
</tr>
</tbody>
</table>

211. Furthermore, by trying to achieve its multiple objectives, APB creates an environment which could prevent the emergence of sustainable MFIs and the involvement of the private sector in the business of importing agricultural supplies.

212. APB has valuable objectives. But it is inefficient to try to achieve all these objectives through a single institution like APB. A narrower mandate for APB would probably improve on the current situation, creating financial transparency and efficiency.

213. **Microfinance.** As we have seen in Chapter III, the microfinance industry is still at an early stage of development in Lao PDR. Recent efforts were made to raise awareness about its potential and in 1997 the government established the Microfinance Coordinating Committee (MCC) composed of BOL, MOF, LWU, APB, CIC, MOFA. The MCC trained officials and organized several study tours. A microfinance national training center was recently established (July 1999) to train practitioners in best practices. However, there are only three microfinance initiatives of significant scale since 1996, with active participation of GOL, donors and NGOs. These projects are now reaching a stage where they are trying to transform themselves into full fledge institutions but the environment has yet to become supportive.

214. With regard to the nature of financing provided, MFIs finance essentially small trade and working capital (poultry, cash crops and small handicraft). In the provinces of Oudomxay, Sayaboury and Vientiane, four microfinance service units have been established with the aim of developing them into viable formal sources of microfinance and providers of microfinance services. These service units provide 6-month loans that charge 4.0 percent interest per month, and borrowers receive 1.8 percent per month on compulsory deposits mobilized.

215. The largest rural credit sources remain family, friends, and household-to-household loans. Informal arrangements, in particular the so-called “village revolving funds” (VRFs), have grown significantly in the last eight years. Their financial service focuses on credit (about

---

This is also under the UNDP/UNCDF microfinance project.
US$5 million in 1996) with limited saving mechanism. Terms, conditions and methods for loan disbursement vary widely among donor-supported projects. For livestock production, farmers borrow young cows, piglets and hen layers from in-kind animal banks. Most of these development project components do not plan for sustainability and often offer subsidized lending rates.

**B. PRIVATE SECTOR**

216. The Government recognizes that poverty reduction rests on economic growth and social stability and has ambitious growth objectives with projected growth rates of 6 to 7 percent per annum over the medium term. A critical question is: what strategy will Lao need to pursue in order to return to and sustain a rapid growth of the economy? International experience shows that when the share of private sector contribution to the economy increases, then the economy becomes more efficient and GDP grows faster. To underpin that growth, the Government has an essential role in providing public goods such as the market infrastructure including a supportive financial system. Furthermore, this is entirely consistent with the Government strategic decision to decentralize based on the principle that efficiency in the development process will improve when decisions are made closer to the site of action and by the people who stand to gain or loose the most.

1. The Rationale

217. The private sector outperforms the public sector in delivering private goods and services because private companies operate under a framework of clear incentives. Failure is sanctioned by an exit of the market while success is rewarded by more resources available.

218. A strong private small and medium-sized enterprises (SME) and micro-enterprise sector is the most efficient method of ensuring that benefits of growth are shared across the entire population through employment and income generation for a growing labor force.

219. With limited resources (human and financial) and greater claims on those resources, the Government can no longer afford its current role in the economy. By handing over the responsibility of the production of private goods and services to the private sector, the Government can free resources (human and capital) and better meet the demand of a growing population for public goods such as health, education and security.

220. Social stability is fostered by private sector led economic growth as the private sector integrate a larger share of the population and the workforce is empowered and share the economic benefits of growth.

221. Finally, the Government of Lao PDR has committed the country with international treaties to be part of the regional economy (ASEAN and AFTA) and the world economy (WTO). It is believed that the private sector has an important role to play in the process of delivering a meaningful integration through foreign trade and investment. For all these reasons, the Lao Government may want to benefit from Private Sector Development (PSD).
2. International Experience

222. It is valuable to learn from other countries’ experiences. China is a good example of private sector-led growth. The Private sector (including the township and village enterprises, the small and medium private enterprises, and foreign invested enterprises) has been growing much faster than the state sector in the last decade and was the principal contributor to China average growth of nine percent over the last 18 years. In 1985, the Chinese economy was dominated by state-owned enterprises (SOEs), that accounted for two-thirds of total industrial output. By 1996, SOEs’ share in industrial output was merely 28 percent, a decline of more than 30 percentage points. This share was filled in by collectively-owned enterprises (39 percent), private small and medium enterprises (15 percent), and private and foreign firms (17 percent).

223. Non-state enterprises have also created more new employment than SOEs in China. The employment level in the state sector, including governments and state-owned enterprises, had been relatively stagnant during 1985 to 1996. Only 16 percent of the 135 millions new non-agricultural jobs during 1985 were created by the state sector.

224. Vietnam, drawing on the China experience, passed a new domestic enterprise law in January 2000 that made entrepreneurship right rather than a privilege. The authorities in Vietnam now seemed convinced that private enterprises can contribute significantly to the growth of the economy particularly by being very efficient.

225. In Eastern Europe, privatized firms outperform comparable SOEs almost invariably. Based on several thousands privatized firms in transition countries, a study by the IMF\(^\text{57}\) shows that, SOEs’ annual productivity growth is five times lower than for comparable privatized firms. Everywhere, private enterprises are by and large more efficient and generate more growth.

226. Growth of manufactured exports which originate primarily from the private sector, boosts overall economic growth in several ways: it accelerates economic specialization and fosters technological progress by allowing exporting firms to learn by doing, it promotes higher rates of capital investment in profitable export sectors, and it provides the foreign exchange needed to finance imports of capital goods. Manufacturing export growth also confers a range of other benefits on an economy, in particular, success in exporting has important spill-over and demonstration effects on other sectors of the economy. A cross-country growth analysis conducted by the Asian Development Bank also provided strong evidence of the close links between manufactured exports and overall growth.\(^\text{58}\)

227. Manufactured exports provided much of the growth in East Asian countries from 1970s through 1990s, lowered poverty and helped to modernize the economies in the region and sustain their growth. From 1965 to 1990, Japan emerged as the world’s largest exporter of manufactured goods, increasing its share of the world market from nearly 8 to almost 12 percent. In the 1970s and 1980s, the locus of growth shifted to four newly industrialized economies (Hong Kong, Singapore, Taiwan, and Republic of Korea), whose share of manufactured exports grew nearly four times faster than Japan’s. Beginning around 1980, the three Southeast Asian

\(^{57}\) Privatization in Transition Countries, 1999. IMF
\(^{58}\) Asian Development Bank (1997), Emerging Asia: Changes and Challenges. P. 86.
countries (Thailand, Malaysia, and Indonesia), which had been historically dependent on commodity exports, recorded a similar surge in manufactured exports.\textsuperscript{59}

3. The Private Sector in Lao PDR

228. The poor state of data resources and knowledge base regarding the role of the private sector in the economy makes it difficult to (a) draw a baseline from which to measure progress (b) identify client bases in the private community, and (c) understand the specific issues facing private enterprises. With the quasi-state sector, cooperative, and informal sector enterprises all operating in parallel with a true private sector, it is even more critical to understand current conditions and follow progress. What is undisputed is that the private sector is at an early stage of development. Most private activities involve foreign investment (usually Thai owned and operated garment firms) micro-enterprises, cottage industries and subsistence farming. But with only about 10 percent of labor force in the non agriculture sector, the private sector potential to create jobs is very large.

229. \textit{Lao private sector profile: SMEs and micro-enterprises involved in retail and trade.} Partly as the result of the transition process to a more market economy, the profile of the private sector in Lao PDR is a mixed set of informal and formal firms with multiple forms of ownership and various degrees of linkages with the Government. A privatization program started 1994 but then slowed as many former SOEs were only leased rather than fully privatized. So, (i) SOEs, (ii) leased SOEs, (iii) joint ventures between foreigners and the government, (iv) joint ventures between foreigners and Lao private citizens, (v) wholly owned foreign firms, and, (vi) 100 percent domestically owned private firms, all coexist in an a very small economy.

230. Nevertheless, it is clear that the \textit{formal private sector} in Lao PDR, as most transitional economies, is small in terms of number of firms, and in terms of company size, unsophisticated and consists of a large number of micro-enterprises and a limited number of manufacturing firms. The largest firms are the garment factories, employing an average of almost 400 workers, but these are almost all foreign owned or at least foreign controlled. Joint ventures between foreign and government and foreign with Lao companies are typically the next largest. Total employment in private companies is roughly 50,000. According to limited evidence, there are around 800 –1000 registered majority private firms with assets greater than $100,000. There are less than 100 firms with more than 100 workers, around 300 with 30 to 99 workers and another 600 enterprises with 10 to 29 workers.

231. At least half of all of these firms are trading companies. The private sector is also present in wood processing and sawmills, exporting furniture products, cabinets and flooring. Construction companies are highly represented in the private sector based on numerous donor funded government infrastructure projects as well as tourism projects. The private sector is also involved in some manufacturing, particularly in the processing of agricultural products: coffee, ginger and eucalyptus, and in more advance food processing in a limited way.

232. Attempts to document the size and structure of the \textit{informal sector} by GTZ in 1996 estimated that there were 146,000 informal small and micro enterprises in Lao PDR employing

\textsuperscript{59} World Bank (1993), \textit{The East Asian Miracle}, p. 37.
260,000 people. More than half of these micro enterprises were one-person business and 60 percent home-based. Three quarters of the firms operated in rural areas and only 13 percent were located in the five largest urban areas. Less than 10 percent of the firms had paid employees. As expected, given the low capital needs and short time horizon for cash flow, the dominant activities carried out are wholesale and retail trading (50 percent of these firms). Other sectors highly represented include 30 percent in manufacturing (mostly handicrafts) and the remainder in services (8 percent) and transportation.

233. **The Lao industry: low value added processing.** In contrast to agriculture which employs most of the population and accounts for more than half of GDP, industry accounted for only 22 percent of GDP at the end of 1998. Manufacturing accounts for three-quarters of industry contribution and a quarter is split between construction and hydropower. More than half of manufacturing output comes from food processing, garments, and wood processing with other substantial contributions from tobacco and non-metal mineral processing. Furniture, chemical and electronics industries also produce significant manufacturing output. (See Table 11).

234. Given limited purchasing power in the domestic market, manufacturing can be characterized by two basic activities: 1) transforming imported inputs into higher value-added exportable products and 2) private sector exploitation of natural resources on behalf of the State. Principal exports are garments (with high import content), electricity, timber and coffee. Manufactures other than garments and wood products account for less than three percent of total exports. Relatively high transport and labor costs hinder Laos’ competitiveness.

| Table 11. Manufacturing Industrial Sector (in Fixed Price 1990 kip/in million) |
|---------------------------------|--------|--------|--------|--------|--------|
| Food Processing Industry        | 22,092 | 14,106 | 17,861 | 20,263 | 21,992 |
| Wood Processing                 | 39,724 | 25,880 | 20,237 | 20,590 | 18,047 |
| Garment                         | 565    | 11,790 | 12,379 | 13,616 | 15,300 |
| Tobacco Processing              | 6,674  | 11,867 | 11,132 | 10,881 | 12,366 |
| Non-metal mineral Processing    | 1,815  | 5,095  | 6,374  | 7,958  | 8,970  |
| Furniture                       | 772    | 6,755  | 7,384  | 8,048  | 7,351  |
| Electric Machine                | 63     | 2,708  | 5,556  | 5,380  | 5,428  |
| Chemistry                       | 1,793  | 3,732  | 3,859  | 4,239  | 4,353  |
| Metal Working                   | 2,471  | 1,980  | 4,021  | 3,529  | 3,798  |
| Plastic                         | 535    | 1,896  | 6,755  | 3,192  | 3,387  |
| Leather                         | 0      | 284    | 341    | 344    | 345    |
| Textile                         | 222    | 219    | 217    | 282    | 280    |
| Printing Paper                  | 120    | 205    | 225    | 212    | 221    |
| Other Repairs                   | 27     | 151    | 151    | 204    | 190    |
| Equipment Machinery             | 61     | 45     | 51     | 67     | 69     |
| Total                           | 78,924 | 88,708 | 98,539 | 100,802| 104,095|

*Source: Ministry of Industry & Handicraft*

235. Among the three main sub-sectors, the garment industry is the most dynamic one. As shown in Table 11, output of the garment industry was only Kip 565 million in 1990. However,
it increased in constant price to Kip 15.3 billion in 1998, which was 26 times higher than that of 1990. Garment industry is also one of the largest exporter in the Lao’s economy, comprised some 20 percent of total export of the country in 1998, as shown in Table 12.

236. The garment industry consists of 65 companies with about 50 in Vientiane. Garment manufacturers are large in terms of their number of employees. Most of these firms are either wholly owned foreign companies or joint ventures with foreign management control. Thai investment is significant in this sector. Almost all the production of the entire industry is exported hence the dependence on market access and international agreements such as the Generalized System of Preference provided by the European Union. However, because those firms work on a “cutting making trimming basis” or CMT, they are also dependent on imported inputs (imported materials constitute about 60-70 percent of costs of production). Foreign partners control financing of the raw material and the purchase of their export output. Lao labor is extensively used on the shop floor but key middle and senior management is generally expatriate.

### Table 12.

**Major Exports by Industrial Products (1998)**

<table>
<thead>
<tr>
<th>Export Products</th>
<th>Export Products (US$ million)</th>
<th>Share in total exports (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Garments</td>
<td>70</td>
<td>20.8</td>
</tr>
<tr>
<td>Electricity</td>
<td>61</td>
<td>18.1</td>
</tr>
<tr>
<td>Wood products</td>
<td>115</td>
<td>34.1</td>
</tr>
<tr>
<td>Agricultural products</td>
<td>8</td>
<td>2.4</td>
</tr>
<tr>
<td>Coffee</td>
<td>48</td>
<td>14.2</td>
</tr>
<tr>
<td>Motorcycles</td>
<td>18</td>
<td>5.3</td>
</tr>
<tr>
<td>Others</td>
<td>17</td>
<td>5.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>337</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: IMF.

4. Importance of Adequate Financing: an Illustration

237. The following example, and there are many similarities with the wood industry, illustrates how the weakness in the financial sector (dominated by technically bankrupt SOCBs with limited financing skills) is detrimental to the whole Lao industry and therefore to the country.

238. In the garment industry, most enterprises work on a CMT basis. This means that Lao enterprises provide the labor and the facilities while the principal sources all the orders and supply the textile and accessories from abroad. Obviously, the profit margin and the bank financing needs on such transactions are small. Lao PDR would be better off if such firms could work on a FOB basis instead. But currently this is almost impossible due to the lack of adequate trade financing supplied by the banks. This lack of available financing appears to be the result of (i) limited range of financial products within Lao banks, (ii) limited risk management skills and (iii) perception, by international banks, that Lao country risk is high.
Box 5.
Creating a Vibrant Enterprise Sector

Clearly, an effective banking sector and a competitive corporate sector are interdependent. Enterprises need an access to capital at a cost supportable by business operations, while banks need a base of enterprises capable of timely repayment of principal, plus interest commensurate with risk. The failure of either party severely impacts the effectiveness of the other.

Of much debate in transition economies such as Lao PDR, is the question of how to create a vibrant private sector. In light of international experience, it appears that the choice facing Laos is not whether or not to reform SOEs. Rather the choice is whether to reform SOEs gradually through private sector competition and the enabling business environment, or to reform SOEs immediately to reap the efficiency gains from privatization. In either case, progress in the enabling environment for business is essential.

The empirical evidence indicates clearly that privatized firms in developing and developed economies are more efficient and prove more beneficial to a country’s welfare than public enterprises. In Chile, the telephone operator doubled capacity after privatization, the Mexican telephone operator dramatically reduced its per unit costs after privatization, while in the UK, service quality has increased and prices were reduced by over 20% after privatization. The World Bank recently reviewed 52 empirical studies comparing public and private sector performance, and found private performance significantly superior results in 32 studies, public performance superior in five studies (15 studies where inconclusive). In the five cases where performance was said to be superior under public sector management, the enterprises were all natural monopolies in water and power. The superior performance of the private sector can be traced to four factors:

**Ability to adapt to market incentives.** Competitive pressure forces private enterprises to respond to operating or market challenges through innovation to improve services or lower costs. While nominally commercialized, SOEs in Laos often serve multiple objectives -- including an important social responsibility to employees in a country which has not socialized its pension and health system, as well as administrative requirements to serve particular markets at particular prices (such as the pharmaceuticals). These objectives often conflict with the ability of SOE managers to make purely competitive decisions.

**Performance monitoring and accountability.** Private investors, particularly supported by appropriate corporate governance regimes, exercise financial and operational oversight to make and monitor investment decisions. This sharpens the accountability of management toward the specific goal of maximizing enterprise value. Financial oversight of SOEs in Laos is often inconsistent. Multiple reporting lines and multiple objectives limits the accountability of management.

**Ability to attract capital.** The transparency of private enterprises makes them more attractive to potential investors, while the potential liabilities of SOEs makes them less attractive. Hence, unable to tap private investment and facing capital rationing by the state, SOEs often become weaker and fragile.

**Flexibility in organizational structure.** The heavy social burden and multiple objectives often force SOEs to carry a larger organizational structure than a similar firm would under private, commercial ownership. The larger organizational structure, in turn, limits flexible competitive response.

Despite the benefits, restructuring SOEs can be costly and politically difficult. China has chosen to develop a gradualist SOE reform strategy that emphasizes the introduction of new enterprises as competitors to SOEs, along with the creation of an enabling environment for private sector development. The shift in employment in China between 1995 and 1997, in which industrial SOE employees dropped by 3.6 million and private-sector employment rose by 12 million is clear evidence that the approach can have a meaningful impact. Stiglitz, among others, sees this approach as beneficial so long as sustained progress is made on the institutional underpinnings of competitive markets-- accounting, legal and corporate governance frameworks, competition policy, and a sound banking system able to enforce a hard budget constraint on SOEs\(^a\). However, the long-term cost-benefit analysis of this approach has yet to be seen.

---

\(^a\) *Second Generation Reform Strategies for China*, Address at Beijing University, August 1998.
5. Role of Lao Government in Private Sector Development

239. The role of Lao Government is critical to actively ensure that entrepreneurship and competition are supported and fostered. More market orientation does not necessarily mean less government but rather a change in its role. The Government has three different roles. First, to ensure clear rules of the game which are enforced in a timely and cost effective way. Second, to provide public goods with positive externalities including an appropriate environment for the banking and financial sector. Third, in a transitory role, to ensure that the process of divestiture from productive activities is fair and transparent and contributes to building a strong private sector base. Furthermore, this is entirely consistent with the Government strategic decision to decentralize seeking to improve efficiency in the development process by allowing decisions to be made closer to the site of action and by the people who stand to gain or lose the most.

240. The legal and regulatory framework (i.e. the rules of the game). Since the legal and institutional framework for the private sector was liberalized in the 1980s and again in the early 1990s, the Government has played a mixed role in the Lao economy setting the rules of the game while also participating in the game through owning productive assets and directing resources. This situation obviously creates conflicts of interests within the Government: conflicts between its role of regulator and its role as an owner but also conflicts between its role as owner of an SOE and an SOCB. This is illustrated by the current financial position of the state-owned banks of some SOEs and the consequences on the Lao economy.

241. The rules of the game are somehow incomplete, often too complex and not always implemented in a predictable manner. While the Government must ensure public security, there seem to be a consensus about the long and costly bureaucratic legal procedures that must be followed to obtain Government approval for registration and operation in Laos. This creates possibilities for rent-seeking activities. As a result of the legacy of licensing the private sector to exploit the natural resources, all private sector activities require multiple levels of licensing from various institutions. Licensing is required for start up, expansion and trade for both domestic and foreign private enterprises. The many approvals and clearances associated with the system of licenses requires a substantial amount of management resource and time. Not surprisingly, many small companies end up operating informally, making payments when needed to retain the business status to the detriment of fiscal revenues.

242. Provision of public goods. Education is a public good and the government is responsible to provide the adequate education to the Lao people. The public sector would then be responsible to providing skills directly or creating the right incentives (on the job training for example). There are needs in many areas not only business-related skills such as language, computers, business accounting and credit analysis but also vocational skills such as construction, plumbing, electrical, mechanical and servicing.

243. Basic infrastructures such as roads and maybe initially industrial sites, are also important public goods that the government must provide to support private sector by improving competitiveness, hence growth and development.

244. The private sector requires also some institutional support. Generally it is provided either through business associations such as the Chamber of Commerce or the Government itself. The
Chamber is intended to act as a voice for the private sector and as such be independent from the Government. The Lao Chamber of Commerce has 500 state-owned and private members. It addresses specific issues in collaboration with the State, but appears to follow closely the government’s policy line.

245. Ensuring that a customer oriented robust banking and financial system supports private sector is an essential public good for which the Government is responsible. Macroeconomic stability and financial sector friendly policies are essential tools to ensure the existence and development of such a system.

246. The Government is also responsible to promote Lao PDR and its products abroad. Such actions support exporters’ marketing efforts and raise awareness among potential international investors to consider Lao PDR as a potential “investing destination.”

247. **Process of divestiture.** When transitioning from a centrally directed economy to a more market oriented economy, the Government of Lao PDR should ensure that each transaction contributes to strengthening the necessary underpinning of a market economy. This was not always the case. Progress was achieved when 600 state-owned enterprises in the early 1990s were fully or partially privatized. But it seems that financial discipline did not improve in resource allocation as there seems to be still directed credit to these enterprises.
**ANNEX 1.**

**COMPARISON OF CURRENT PRUDENTIAL GUIDELINES IN LAO PDR WITH THE 25 CORE PRINCIPLES FOR EFFECTIVE BANK SUPERVISION**

<table>
<thead>
<tr>
<th>Basle Principle no.</th>
<th>Perfect</th>
<th>Adequate</th>
<th>To be improved</th>
<th>To be changed</th>
<th>Comments: Main reason for rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 objectives and means</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td>Article 43 does not provide a mission statement for supervisors. Little operational independence. No adequate resource &amp; capacity. Uncertain legal protection for supervisor.</td>
</tr>
<tr>
<td>2 definition of a bank and banking activities</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>Articles 2 and 10.</td>
</tr>
<tr>
<td>3 licensing process</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>Articles 5-9</td>
</tr>
<tr>
<td>4 ownership changes</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>Article 16. Supervisor’s ability to reject changes in ownership in question.</td>
</tr>
<tr>
<td>5 major acquisition or investment</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>Article 42. Lack of detail.</td>
</tr>
<tr>
<td>6 capital</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>Article 11. Clarification needed with respect to branches and subsidiaries.</td>
</tr>
<tr>
<td>7 lending policies</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>BOL issues Notices and instructions</td>
</tr>
<tr>
<td>9 loan concentration</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>03/BOL Jan 15 1996. Group exposure at 10% of capital is strict.</td>
</tr>
<tr>
<td>10 connected lending</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>03/BOL. Simple definition but adequate for the context.</td>
</tr>
<tr>
<td>11 country risk</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>No rule</td>
</tr>
<tr>
<td>13 risk management systems</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>Not well defined. No specific regulation</td>
</tr>
<tr>
<td>14 internal controls</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>Article 44 and Instruction Bol/91 April 9, 2001.</td>
</tr>
<tr>
<td>Basle Principle no.</td>
<td>Perfect</td>
<td>Adequate</td>
<td>To be improved</td>
<td>To be changed</td>
<td>Comments: Main reason for rating</td>
</tr>
<tr>
<td>-------------------</td>
<td>---------</td>
<td>----------</td>
<td>----------------</td>
<td>---------------</td>
<td>----------------------------------</td>
</tr>
<tr>
<td>15 Money Laundering rules</td>
<td></td>
<td></td>
<td>✓</td>
<td></td>
<td>No specific regulation</td>
</tr>
<tr>
<td>16 on and off site supervision</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td>Weak capacity and little resources</td>
</tr>
<tr>
<td>17 relation between management and supervisors</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td>Standing of supervisors vs. status of banks top management particularly SOCBs.</td>
</tr>
<tr>
<td>18 Analysis of banks data</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td>Need adequate conceptual framework and tools.</td>
</tr>
<tr>
<td>19 independent validation</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>Articles 45 and 64. External audit should take place.</td>
</tr>
<tr>
<td>20 consolidated supervision</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Not applicable</td>
</tr>
<tr>
<td>21 accounting policies</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>Specific accounting standards, but off balance sheet items not recorded consistently and accurately.</td>
</tr>
<tr>
<td>22 problem banks</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td>Regulations 04/BOL &amp; 06/BOL Jan 15 1996 Lack of precision</td>
</tr>
<tr>
<td>23 scope of supervision</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>24 information exchange</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td>Little exchanges between supervisory agencies</td>
</tr>
<tr>
<td>25 identical framework for domestic and foreign banks</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td>Article 11: Capital requirements are different for Lao owned and foreign owned banks.</td>
</tr>
</tbody>
</table>

**N.B.:** Articles mentioned are part of the Decree Law No. 2 dated March 22, 2000 on Commercial Banks.
ANNEX 2.
HISTORY OF THE LAO BANKING SYSTEM

Annex 2 Table 1.
The Commercial Banks Established in the First Period of Reforms, 1988-91

<table>
<thead>
<tr>
<th>No</th>
<th>Name</th>
<th>Founded</th>
<th>Remark</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Nakhoneluang Bank</td>
<td>1988</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Sethathirath Bank</td>
<td>1988</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Joint Development Bank</td>
<td>October 1989</td>
<td>70% of equity-Thai investors 30% of equity- the Lao central bank</td>
</tr>
<tr>
<td>4</td>
<td>Banque pour le Commerce</td>
<td>November 1989</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Exterieur du Lao (BCEL)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Pak Tai Bank</td>
<td>1990</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Lao Mai Bank</td>
<td>1990</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Lane Xang Bank</td>
<td>1990</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Aroun May Bank</td>
<td>September 1991</td>
<td></td>
</tr>
</tbody>
</table>

Annex 2 Table 2.
The Commercial Banks Established in the Second Period of Reforms, 1992-95

<table>
<thead>
<tr>
<th>No</th>
<th>Name</th>
<th>Founded</th>
<th>Remark</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Siam Commercial Bank</td>
<td>December 1992</td>
<td>Branch</td>
</tr>
<tr>
<td>2</td>
<td>Thai Military Bank</td>
<td>1993</td>
<td>Branch</td>
</tr>
<tr>
<td>3</td>
<td>Thai Farmers Bank</td>
<td>1993</td>
<td>Branch</td>
</tr>
<tr>
<td>4</td>
<td>Krungthai Bank</td>
<td>1993</td>
<td>Branch</td>
</tr>
<tr>
<td>5</td>
<td>Bangkok Bank</td>
<td>1993</td>
<td>Branch</td>
</tr>
<tr>
<td>6</td>
<td>Ayoudya Bank</td>
<td>1994</td>
<td>Branch</td>
</tr>
<tr>
<td>7</td>
<td>Vientiane Commercial Bank</td>
<td>1993</td>
<td>Joint venture bank, 25% of capital-Lao private investor, 75% - foreign investors</td>
</tr>
<tr>
<td>8</td>
<td>Agricultural Promotion Bank</td>
<td>July 1993</td>
<td>Policy bank – state owned</td>
</tr>
</tbody>
</table>
Annex 2 Table 3
Current Structure of the Commercial Banks in Lao

<table>
<thead>
<tr>
<th>No</th>
<th>Name</th>
<th>Remark</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>State-Owned Commercial Banks</strong></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>BCEL</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Lane Xang Bank</td>
<td>Consolidated from Lane Xang, Sethathirath, Aroun Mai banks in 1998.</td>
</tr>
<tr>
<td>4</td>
<td>Agricultural Promotion Bank</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Joint Venture Banks</strong></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Joint development Bank</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Ventiane commercial Bank</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Foreign Bank Branches</strong></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Siam Commercial Bank</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Thai Military Bank</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Thai Farmers Bank</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Krungthai Bank</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Bangkok Bank</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Ayoudya Bank</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Public Bank</td>
<td>Malaysian bank branch</td>
</tr>
<tr>
<td></td>
<td><strong>Representative Office</strong></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Standard Chartered Bank</td>
<td></td>
</tr>
</tbody>
</table>
ANNEX 3.

FINANCIAL ANALYSIS OF BANQUE POUR LE COMMERCE EXTERIEUR LAO

1. Banque Pour Le Commerce Exterieur Lao (BCEL) is mainly the result of the 1988 spin off of the central bank’s branches in Vientiane prefecture which performed most of the international transactions.

2. BCEL, a state-owned commercial bank (SOCB) wholly owned by MOF, dominates the country’s banking market. BCEL is mainly involved in trade-finance and services, such as letters of credit, import and export settlements. BCEL is insolvent. BCEL has six branches including two opened in 2001. Head Office control over branches is weak.

Governance

3. The Board of Directors should be the policy making unit of the bank. The Minister of Finance appoints the Chairman but BOL must approve. MOF appoints the Vice Chairman (in practice the managing director) who must be nominated by BOL. MOF appoints the other members of the board. Despite some recent improvements, BOL influence remains pervasive in BCEL management and in particular in the nomination of senior management, organizational changes and information disclosure. Directors have had little or no corporate governance exposure, have not met regularly, generally lack business qualifications.

Financial Situation

4. During 1999, BCEL’s total assets reached to Kip 1.5 trillion (US$ 194 million equivalent); this represents a more than 100% nominal increase resulting essentially from the kip devaluation. Reflecting the extent of the dollarization of Lao economy, almost 90 percent of the bank’s assets were denominated in foreign currencies (see Annex 3 Table 1) and in US$ terms, the total balance sheet remained stable.

<table>
<thead>
<tr>
<th>Currency Composition of BCEL Assets (Sept. 30 1999)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kip, Bln</td>
</tr>
<tr>
<td>---------</td>
</tr>
<tr>
<td>Kip equiv. bn</td>
</tr>
<tr>
<td>Percent</td>
</tr>
</tbody>
</table>

1 Based on unaudited figures and domestic accounting standards.

2 Exchange rate: 6,550 kip per dollar and 160 kip per baht as of September 30, 1999.

3 FX assets account between 50 percent and 70 percent in the other banks.
5. During the 1997 to 1999 period, the balance sheet composition evolved: the liquid assets increased from 45% in 1997 to 60 percent of total in 1999, while loans decreased from 38% in 1997 to 26 percent at year end 1999. (See Annex 3 Figure 1).

6. One contributing factor to this high level of liquid assets is linked to BCEL’s trade finance activity: the bank only opens LC’s with 100% cash cover. However, it seems that deposits linked to trade related activities only account for approximately 5% of deposits. According to BOL consultants, the amount of liquid assets specifically linked to that activity is only recorded recently (1999).

7. As of September 1999, BCEL’s total loan portfolio stood at Kip 392 billion equivalent as about 90% of loans are in foreign currency. Loan-to-deposit ratio stood at 39 percent evidencing a low level of lending activity.

8. Nevertheless, the stock of non-performing loans (NPLs) stood at Kip 345 billion, i.e. 88 percent of total loans. This is essentially the result of poor risk management. Most NPLs (60 percent) are loans to SOEs. Total estimated necessary provisions amounted to 90 percent of non-performing assets compared to virtually no recorded provision as of December 31, 1999.

---

4 The reported figures in kip varied widely because most of the portfolios were denominated in foreign currencies and the exchange rate fluctuated widely in 1999. (4.300 kip – 9,430 kip per dollar)

5 Source: cf. ADB Aide-mémoire, August 1999 – Appendix 1.
Annex 3 Table 2.
Loan Portfolio Status
(June 30, 1999)

<table>
<thead>
<tr>
<th>Loans</th>
<th>Kip mln</th>
<th>US$ (000)</th>
<th>Baht (000)</th>
<th>Total loans (kip mln)</th>
<th>As (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>52,615</td>
<td>52,615</td>
<td>12</td>
<td>461,009</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>42,839</td>
<td>403,972</td>
<td>88</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>17,275</td>
<td>4,422</td>
<td>-</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Loan classification
- Performing | 55,321 | 12% |
- Non-performing | 405,688 | 88% |
- Substandard | 13,830 | 3% |
- Doubtful | 50,711 | 11% |
- Loss | 341,147 | 74% |

Loan Loss Provision
- Actual | 983 |
- Estimated | 350,439 |
- Deficiency or expected losses | 349,456 |

Source: BOL Consultants and staff estimates.

9. A capital deficit of Kip 290 billion ($39 million equivalent) would be apparent if BCEL were to comply with current Regulation on Loan Classification of Commercial Banks (Regulation 01/BOL - May 96 revised 98) and provisions made accordingly.

10. With the assumption that there is no other asset or off-balance sheet commitments\(^6\) of doubtful value, BCEL needed a recapitalization of Kip 350 billion ($47 million equivalent) to comply with present BOL regulation (Regulation 02/BOL/1996) on capital adequacy (an 8 percent ratio). However, in the Lao context (i.e. a concentrated small economy) a higher ratio would be more adapted.

Sources of Funds

11. As of December 31 1999, BCEL’s main source of funds was deposits which accounted for 67 percent of total liabilities i.e. Kip 985 billion. Dollar deposits accounted for 76 percent of total customers deposits i.e. about US$100 million (see Annex 3 Figure 2).

\[^6\] There is no reliable data on off-balance sheet liabilities.
12. In 1999, while FX deposits remained stable, Kip deposits decreased by more than 50 percent in real terms, evidencing further loss in confidence in the domestic currency.

13. More than 15% of BCEL’s balance sheet was funded by BOL. Most of these funds were in US$(22.3 million). It appears that BOL is contributing to fund BCEL’s USD loan portfolio. BOL is probably providing credit to SOEs through BCEL.

14. From 1999 BOL’s balance sheet, it appeared that funds collected by BOL in the course of implementing its monetary policy through reserve requirement and the issuance of CD, are on-lent essentially to BCEL and APB: BOL collected about Kip 302 billion and deposited 73% with BCEL and 25% with APB. This may not be the most appropriate way to handle those funds as it may conflict with monetary objectives i.e. a reduction of funds available in the banking system.

**Liquidity**

15. BCEL’s total liquid assets (cash, central bank deposits and “due from banks”) rose from Kip 335 billion in 1998 to Kip 842 billion in 1999, a 150 percent nominal increase. At year end 1999, BCEL had a cash-in-vault ratio\(^7\) of 5 percent which is consistent with BOL’s requirements of 4 to 8 percent.

16. Liquid assets stood at 57 percent of total assets mostly in US dollars and held in outside the country in *nastro* account (37% of total assets). BCEL also complied with the reserve requirements holding more (14%) than required (12%) with BOL.

17. At year end 1999, BCEL is clearly liquid. The ratio liquid assets-to-customers deposits\(^8\) stood at 92%. As BCEL is insolvent the closure scenario could be envisaged although it is probably politically unrealistic. In this case, this high ratio means that “non-sophisticated depositors” would get back almost all their deposits, hence the closing of BCEL would not cost too much to the Government. However, liquidity is can vanish quickly.

**Earnings**

18. The bank reported net income of Kip 11.5 billion in 1999, which represented a return of 1.1 percent average total assets. Profitability of domestic operations, however, declined sharply. This is still probably over valued for SOCBs have been accruing interests on NPLs. The negative net interest income in 1998 and 1999, was more than compensated by the non-interest income and the FX results.

19. The fee and commission income is related to its trade finance activity and appears healthy and real. But it is not clear how BCEL derived the positive FX result. The bank certainly benefited in many ways from the exchange rate variations as BCEL is the largest player in the Kip/Dollar market. But most of recorded profit appears to be the result of capital gains. This is not consistent with BCEL being short in US dollars as most of its dollar loans are non-performing.

---

\(^7\) Cash-in-vault ratio = cash / total liabilities

\(^8\) Exclude government deposit
20. BCEL is nominally profitable on paper before loan loss provisions which means that the bank is making heavy losses in reality and it is only a matter of time before it becomes illiquid as it is already insolvent.

**Foreign Exchange**

21. The fluctuations of the exchange rate might affect BCEL through two channels. First, firms that borrow dollar-denominated loans and not able to repay when the Kip depreciates. Second, the bank relies on FX income.

22. For the year 1999, the daily turnover of US dollar is estimated to be around US$200,000 per day, with THB transactions estimated around US$100,000 equivalent. This amounts to US$300,000 per day. The annual returns from foreign exchange can be estimated at US$300,000 or 2.28 billions of Kip\(^9\).

23. According to the income statement of BCEL for 1999, the foreign exchange results are of 17.6 billions of Kip, and the fee and commission returns are of 16.1 billion of Kip. (See Annex 3 Table 3).

### Annex 3 Table 3.

**1999 Simplified Income Statement**

<table>
<thead>
<tr>
<th>Kip million</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest and similar income</td>
<td>30,182.6</td>
</tr>
<tr>
<td>Interest and similar expenses</td>
<td>(32,418.2)</td>
</tr>
<tr>
<td>Net interest income</td>
<td>(2,235.6)</td>
</tr>
<tr>
<td>Fee and commission income</td>
<td>17,601.9</td>
</tr>
<tr>
<td>Fee and commission expense</td>
<td>(1,455.8)</td>
</tr>
<tr>
<td>FX results (net)?</td>
<td>17,586.7</td>
</tr>
<tr>
<td>Other operating income</td>
<td>411.2</td>
</tr>
<tr>
<td>General administration expenses</td>
<td>(2,851.3)</td>
</tr>
<tr>
<td>Tax</td>
<td>(20.9)</td>
</tr>
<tr>
<td>Profit (loss) after tax</td>
<td><strong>11,532.2</strong></td>
</tr>
</tbody>
</table>

### Some unresolved questions

- Off balance sheet – what is the amount of commitments?
- How are credit allocation decisions made for SOEs?
- How did BCEL derive the positive FX result for 1999?
- If the bank did not have to lend to SOEs would its activity be sustainable?

\(^9\)Assumption : the FX commission is 0.5%, and 200 working days per year.
ANNEX 4.
FINANCIAL ANALYSIS OF AGRICULTURE PROMOTION BANK (1999)

1. The *Agricultural Promotion Bank (APB)* is a state owned specialized bank focusing on rural financing. APB is the only institution in the formal sector providing financial services of any significance to the rural households.

2. APB was established in June 1993 by consolidating the agriculture loan portfolios and the staff of the three state commercial banks which were already providing some credit to the agriculture sector. APB has three roles: first, to be a policy bank i.e. to lend at subsidized rates under government instruction; second, to provide subsidized credit to private farmers on an arm length basis; third, to fulfill the role of an agriculture promotion agency: APB imports and provides fertilizer, hand tractors and equipment to borrowers. In his latter role, APB also distributes on behalf of the Lao government, in kind donations from bilateral aid agreements; APB gets a fee for this service.

3. In Lao PDR agricultural sector, there are no direct subsidies for inputs or guaranteed prices for outputs. Subsidies are indirect and incorporated in the APB agricultural credit scheme. APB serves largely as a conduit for agricultural subsidies. Its operations are closely monitored by the Government.

4. APB reaches rural households mainly through subsidized credit to groups and reported that it has established over 20,000 such groups with an average membership of about seven families per group. In the case of credit to groups, group guarantee serves as a collateral instead of tangible assets. Individual loans are also granted, mostly to agro-processing units at higher interests rates (30-34%) against the collateral of land or housing.

5. APB is involved in the Microfinance Policy level, it holds the secretary position in the Microfinance Coordinating Committee (MCC). It also partners with the Microfinance Project to launch microfinance schemes in two provinces.

6. At the end of 1999, APB employed about 490 employees in three branches, 14 service units located in 17 provinces and Vientiane Municipality. At the district level, APB has 47 sub-service units. Out of 144 districts, APB covers 98 and had no operations in 46 districts. APB is the only Lao bank with such a widespread rural network.

**Governance and Regulations**

7. APB’s Board of Directors consists of members from the Ministries of Finance, Commerce, and Agriculture and Forestry. Before 1999, the Board was chaired by the Governor of Bank of Lao PDR. In early 1999 the Managing Director became the Chairman of the Board, and in 2000, the Director of State Assets Department of MOF. APB does not disclose financial information to the public.

8. APB does not come under the commercial banking law in Lao PDR although it is under the supervision of BOL. It has effectively gone unregulated until now no enforcement of the prudential regulations of BOL.
Financial condition

9. The following analysis is based on APB’s balance sheets and income statement of 1997, 1998, and 1999. Most of the figures come from the BOL. APB’s accounts are not audited. Although BOL regularly receives APB’s financial statements but BOL never undertook an in-depth analysis of the institution nor conducted an on-site inspection. APB does not publish an annual report.

10. With total assets of Kip 145 billion (US$ 19.1 million) at the end of December 1999, APB is the smallest among the four state-owned banks, which together dominate (measured by asset size) the country’s banking market.

11. Contrary to BCEL for instance, APB’s balance sheet is essentially denominated in domestic currency. (See Annex 4 Table 1). Currently, APB does not meet the 8 percent capital adequacy requirement: the level reported is 1.7 percent.

<table>
<thead>
<tr>
<th>Annex 4 Table 1.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency Composition of APB Assets (Sep. 30 1999)</td>
</tr>
<tr>
<td>Currency</td>
</tr>
<tr>
<td>Kip equiv bn</td>
</tr>
<tr>
<td>Percent</td>
</tr>
</tbody>
</table>

Asset quality

12. At the end of 1999, APB’s total loans stood at Kip 91 billion; this is a 100% increase compared to December 1998 but in real terms a 16% decrease. Loans accounted for more than 63% of total assets.

13. The bank’s lending activities are subject to close government attention: these are policy objectives most of its loan book remains policy oriented, extended to rural as well as agricultural projects at subsidized rates. APB loan portfolio is approximately split equally between government-sponsored projects and private projects.10

14. Agricultural lending is a risky business because of uncontrollable natural events. We do not have sufficient information to comment on the adequacy of the provisions. But international experience shows that provisions are generally underestimated. At the end of 1999, APB has Kip 474 million provision fund, that accounts for 0.5 percent of total outstanding loans.

15. In Lao PDR, very few have received credit from the formal financial system. One important reason is the poor infrastructure and concentrated banking activity in the major cities. APB loans mostly benefited to easily accessible rural areas and it was able to reach about 5 percent11 of rural families with loans. It is probable that demand for subsidized credit far exceeds supply for subsidized loans. This raises questions on the allocation of credit and the

---

10 We assumed here that policy loans are at subsidized rate and all market rate loans are not directed.
11 Current APB management estimates that this figure may be higher. More accurate data is currently being collected.
transparency of the process. Informal credit therefore remains the major source of funding for farmers.

Annex 4 Figure 1
Compositions of Assets (APB)

Bank Solvency

16. The ratio of non-performing loans to gross loans is quite low, 0.7% at the end of 1999. In the absence of strict implementation of the regulation on loan classification (Regulation 01/BOL – May 1996 revised 1998), it is likely that this be underestimated. Assuming a more realistic level of NPLs, the bank would be clearly insolvent: this is already the case when the level of NPLs reaches 10% of outstanding loans.

17. Unfortunately, financial information is sketchy at best and assumptions must be made to understand the reported figures. For instance, in the balance sheet, other assets probably account for fixed assets, goods and equipment in the inventory reflecting APB promotion agency and cooperative role.

Liabilities

18. APB's funding source consisted of: (i) borrowing from the BOL(61%), (ii) customer deposit (26%), and (iii) government deposit(13%). (see Annex 4 Figure 2)

19. APB had customer deposit of Kip 27.8 billion in 1999 from about 80,000 depositors. The average deposit size has dropped to US$ 46 at year end 1999. The amount of deposit mobilized by APB has increased in nominal terms in 1998 and 1999. Total outstanding deposits have increased from Kip 18 billion at the end of 1998 to Kip 28 billion at the end of 1999. This is a decrease in real terms of 32% reflecting the negative impact on deposits and monetary savings of a high inflationary environment. In addition, APB did not pay positive real interest rates on its deposits.

20. The loan-to-deposit ratio was around 330 percent at the end of 1999, including policy lending, which is far above maximum authorized by BOL i.e. 60 percent.
21. For the one year period ended in December 1999, APB reported total net income of Kip 7.9 billion i.e. US$1.0 million. APB pays taxes at a lower rate than SOCBs: APB paid a tax on profit at a rate of 15 percent.

22. APB is subsidizing agriculture by providing cheap loans. Interest rates charged for paddy cultivation, irrigation, livestock and food production in 1999 varied between 7 to 12 percent while lending rates for non-targeted sectors and services, especially small traders, wholesalers and small businesses, were 30 to 32 percent. These were highly negative rates. During that period we recall that inflation rate were about 120 percent.

23. This corresponds to providing approximately Kip 10 billion in subsidies to the agricultural sector through its borrowers.\(^{12}\)

24. In order to sustain its operation, similarly, APB’s funding is subsidized. The Ministry of Finance, through BOL, funds about 60 percent of APB’s needs at interest rates between 5 to 7 percent. This represent an indirect subsidy to APB of approximately 15Kip billion\(^ {13}\). Therefore APB retains about Kip 5 billion to sustain its operation i.e. one-third of government subsidies to agricultural sector.

---

\(^{12}\) Assuming that the lending market interest rate is 30%.

\(^{13}\) Computations are made with following assumptions: interest bearing assets amount to Kip 95 billion and lending market rate is 30%; interest paying liabilities amount to Kip 107 billion and borrowing market rate is 25%.
Annex 4 Table 2.
Simplified Income Statement

<table>
<thead>
<tr>
<th>Kip million</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest and similar income</td>
<td>12,802</td>
</tr>
<tr>
<td>Interest and similar expenses</td>
<td>(5,350)</td>
</tr>
<tr>
<td>Net interest income</td>
<td>7,452</td>
</tr>
<tr>
<td>Fee and commission income</td>
<td>220</td>
</tr>
<tr>
<td>Fee and commission expense</td>
<td>(140)</td>
</tr>
<tr>
<td>FX results</td>
<td>2,218</td>
</tr>
<tr>
<td>Other operating income</td>
<td>3,543</td>
</tr>
<tr>
<td>General administration expenses</td>
<td>(5,319)</td>
</tr>
<tr>
<td>Tax</td>
<td>0</td>
</tr>
<tr>
<td>Profit (loss) after tax</td>
<td>7,881</td>
</tr>
</tbody>
</table>

25. Without the subsidies, APB would not be sustainable as previous estimates show that banking margin would only cover for general and administrative expense and not provisions and other banking expenses. Currently, APB does not look a very efficient mechanism to channel subsidies to the agricultural sector.

Liquidity

26. The bank’s liquidity measures are poor. At year end 1999, short-term assets (cash and ST deposits with BOL and other banks) stood at 10 percent of total assets. However, this still represents 55% of total customers deposits, which is comfortable. The fact that the government is a major lender positively affects APB’s liquidity.

27. As the bank’s assets and deposits are mainly denominated in Kip, the Bank is not directly exposed to exchange rate fluctuations. At December 31, 1999, APB has a cash vault ratio of 4.2 percent, this was adequate.

Some unresolved questions

- How does the government direct lending?
- What is the average maturity of APB’s loans?
- What is the definition of the private sector that constitutes APB’s main clients?
- Where are donors’ credit lines recorded?
ANNEX 5.
MICROFINANCE: ESTIMATES OF SUPPLY AND DEMAND

The following figures are conservative staff estimates of the potential and actual demand for microcredit\(^\text{14}\). Sources include the National Statistic Center, banks and microfinance practitioners.

Annex 5 Table 1.
Estimated Microfinance Borrowers and Depositors
(2000)

<table>
<thead>
<tr>
<th></th>
<th>Borrowers</th>
<th>Depositors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total population of Laos in 1999(^\text{15})</td>
<td>5,100,000</td>
<td>5,100,000</td>
</tr>
<tr>
<td>Number of households in Laos in 1999</td>
<td>800,000</td>
<td>800,000</td>
</tr>
<tr>
<td>Number of households which can be reached by a Microfinance Institution (70% of households)(^\text{16})</td>
<td>560,000</td>
<td>560,000</td>
</tr>
<tr>
<td>Penetration rates: 40% for credit and 50% for savings</td>
<td>224,000</td>
<td>280,000</td>
</tr>
<tr>
<td>Total number of potential clients assuming 1.2 borrowers per household and 2 depositors per household.</td>
<td>268,000</td>
<td>560,000</td>
</tr>
</tbody>
</table>

Annex 5 Table 2.
Actual Micro-Borrowers and Micro-Depositors
(2000)

<table>
<thead>
<tr>
<th>Supplier</th>
<th>Estimated borrowers</th>
<th>Estimated depositors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money Lenders(^\text{17})</td>
<td>25,000</td>
<td>Nil</td>
</tr>
<tr>
<td>Lane Xang Bank</td>
<td>2,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Agricultural Promotion Bank(^\text{18})</td>
<td>30,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Village Revolving Funds(^\text{19})</td>
<td>8,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Microfinance Institutions</td>
<td>5,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Total</td>
<td>70,000</td>
<td>137,000</td>
</tr>
</tbody>
</table>

\(^{14}\) Microcredit is defined as outstanding loans below Kip 30 million and micro-saving as deposit below Kip 5 million.

\(^{15}\) Source: National Statistic Center

\(^{16}\) 30% of the population live in remote locations and therefore are not accessible.

\(^{17}\) Based on interviews with Microfinance practitioners in urban and rural areas. Dec. 2000 estimates: one money lender in 25% of the villages with five active borrowers.

\(^{18}\) Staff estimates: livestock and handicraft loans are used as proxy for microfinance loans.

\(^{19}\) Source: UNDP/UNCDF Microfinance Profile 1997, and interviews with practitioners. There are approx. 1,600 VRF and five active borrowers per VRF on average.
Annex 5 Table 3.
Estimated Suppliers of Microcredit: Main Features
(December 2000)

<table>
<thead>
<tr>
<th></th>
<th>Formal institution</th>
<th>Projects</th>
<th>Informal Money Lender</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>APB</td>
<td>LX Bank</td>
<td>VRFs</td>
</tr>
<tr>
<td>Years of existence</td>
<td>10</td>
<td>2</td>
<td>8</td>
</tr>
<tr>
<td>Number of active</td>
<td>30,000</td>
<td>2,000</td>
<td>8,000</td>
</tr>
<tr>
<td>borrowers</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Main Loan Use</td>
<td>Agriculture IGAs</td>
<td>Trade IGAs</td>
<td>IGAs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ses</td>
<td></td>
</tr>
<tr>
<td></td>
<td>agriculture IGAs</td>
<td>trade IGAs</td>
<td>IGAs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ses</td>
<td></td>
</tr>
<tr>
<td>Annual loan size</td>
<td>m: ?</td>
<td>M: 200</td>
<td>A: 400</td>
</tr>
<tr>
<td>In ‘000 Kip</td>
<td>M: 30,000</td>
<td>M: 30,000</td>
<td></td>
</tr>
<tr>
<td>Average Interest</td>
<td>0.7%</td>
<td>2.6%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Rate per month (flat method)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Location of Service</td>
<td>Bank</td>
<td>Workplace</td>
<td>Village</td>
</tr>
<tr>
<td>Savings Services</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

NB: The family is also an important source of funds. These loans are usually interest free.

IGAs = Income Generating Activities (these can include some agricultural activities, such as small livestock or transformation of agricultural products)
SE = Small Enterprise
VRF = Village Revolving Funds
MFIs = Microfinance Institutions
m = Minimum
M = Maximum
A = Average
ANNEX 6.

DESCRIPTION OF MAIN AGRICULTURAL PRODUCTS

1. Lao farming systems are low-output, low-income, autonomous and virtually insulated from the rest of the economy. Food supply relies on nature’s bounty and is vulnerable to climatic changes and pests. Most rural families grow rice, own livestock, and have fruit trees and vegetable plots around their homes. Some rural people catch fish in rivers and water bodies and get food from the forest. Linkage of farms to the market economy is weak, as there are no efficient delivery systems to get inputs to farmers and outputs to consumers. As such, agricultural systems are not geared to respond to the needs of a growing population and increasing urbanization.

Rice is the most important subsistence crop

2. In Lao PDR, rice is the most important crop and is produced mainly for local consumption; yields are low. The main constraint appears to be water supply. Other constraints include low soil fertility, insects, pests and poor seed quality as seeds are retained from previous harvest.

3. Rice production is mainly for domestic consumption and local consumer preferences. Surplus quantities of rice produced are exported mainly to Thailand. Although over 90 percent of rice produced are glutinous rice, the demand in the global market is for non-glutinous rice. In Lao PDR, non-glutinous rice production is confined to the dry season in irrigated areas. The variety of non-glutinous rice is of lower quality than the long grain varieties exported by Thailand in the world market.

4. Production cost for paddy is about half the cost in Thailand, estimated in an ADB study in 1997 at about $56 per ton for glutinous rice and $79 per ton for non-glutinous rice. Low labor cost was the main factor for the low production cost. Relatively low use of inputs by rice farmers practicing subsistence farming kept costs down.

5. Rain-fed rice accounts for over 75 percent of the total while irrigated rice covers 25 percent. There are two crops a year one during the wet season and one during the dry season. The central and southern regions account for more than 75 percent of the rain-fed lowland area. Current estimate for upland rice production is 152,000 ha. Yields vary depending on location. (See Annex 6 Table 1.)

6. Better water management techniques and improved water supply can increase crop yield in both seasons as water is a major constraint. There is presently 150,000 ha of irrigated land (27,000 hectares in flatland) and (123,000 hectares sloping land areas). Recently, the subsidized water usage fee increased from Kip 2,500 to 5,000/ha for wet season rice, and from Kip 3,000 to Kip 6,000 for dry season rice.

<table>
<thead>
<tr>
<th>Annex 6 Table 1. Current Average Yield (ton/ha)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowland</td>
</tr>
<tr>
<td>Rain-fed</td>
</tr>
<tr>
<td>Irrigation</td>
</tr>
</tbody>
</table>
7. The Government’s priority for the agriculture sector is to achieve self-sufficiency in rice production and increased diversification for local consumption and exports. The primary goal of the Government until the year 2005 is rice self sufficiency in deficit areas and accelerated diversification in lowland and upland areas. Actually, Lao PDR is close to being self-sufficient on a regular basis: in 1999, it was the case as paddy production reached 2.1 million tons.

8. As of 1997, there were an estimated 15,500 irrigation schemes, with a capacity to service about 164,270 ha, or about 20 percent of the country’s 800,000 ha of annually cultivated land. Most of the irrigation schemes are small and village-based, using traditional weirs. Farmers are encouraged to allocate irrigated land to more profitable crops.

9. Cost recovery and sustainability remain objectives to reach. There has been a gradual shift from large, capital intensive systems towards smaller schemes, and from Government-managed systems to farmer-managed systems. Gravity and pump schemes are being used to increase water supply and irrigate more land during the dry season. In the 3-year period ending 1999, the Government procured and distributed about 7,000 pumps, which are designed to drain fields flooded during the wet season and irrigate in the dry season thus providing opportunities to increase and diversify production.

10. Increased production was achieved and diversification was promoted. But expansion of bank credit for the purchase of irrigation pumps in fiscal year 1997/98 was a significant cause of very high inflation during the ensuing months.

11. To be noted that there is no integrated rice (or other agricultural commodities) market in Lao PDR: wide price disparities persist between the provincial markets. Causes include deficient road and communication infrastructures, poorly developed marketing networks and high costs of collecting relatively small rice surpluses from a large number of farmers scattered over large areas. This lack of integration is a reflection of the early stage in the transformation process of the Lao agriculture from a subsistence sector to a market oriented sector.  

Coffee is the most important cash crop

12. Coffee is the most important cash crop in Lao PDR and on the list of country’s strategic goods. Yields are very low due to the little use of inputs such as fertilizers and pesticides. Quality would improved if better coffee varieties were planted.

13. Coffee covers 25,000 ha and is by far the agricultural products largest foreign exchange earner (excluding forestry). Robusta accounts for 80 percent of production while arabica for 15 percent and liberica for 5 percent. The average plantation’s size is around two hectares with low yields of 450-550 kg/ha. Coffee production increased after 1994, when its price rose. The coffee area expanded rapidly over the past 20 years at an average annual rate of about 7.6 percent. (See Annex 6 Figure 1). Coffee production cost for Lao PDR was about 50 percent higher than Indonesia in 1997. New plantings of coffee has improved the yields and lowered production cost.

---

20 Emerging Rice Market in Lao PDR? By Yves Bourdet, University of Lund Sweden 2000.
21 The price of coffee increased from Kip 400/kg in 1994 to Kip 3,000-5,000/kg in 1998, (which is double the price of Kip 2,500 in 1997).
14. Government has encouraged production: in 1995, it removed the tariff on coffee exports and exempted coffee growers from duty on imported farm equipment.

15. With improved husbandry, including pruning, fertilizing and weeding, yields increased from 200 kg/ha to 650 kg/ha although lower than what was expected, i.e., 800 kg/ha. Lao’s robusta is exported mainly to Europe.

**Livestock’s importance is increasing**

16. Livestock and fisheries has gained importance in recent years; the lack of public facilities constrains growth of this sub-sector and prevents local processing.

17. Livestock and fisheries contribute about 40 percent of agriculture production with further export and income-generating potential. Rural households maintain a variety of livestock including buffalo, cattle, pigs and poultry.

**Annex 6 Table 2. Composition of Livestock (‘000 of head)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Buffalo</td>
<td>1,134</td>
<td>1,168</td>
<td>1,191</td>
<td>1,212</td>
<td>1,224</td>
</tr>
<tr>
<td>Cattle</td>
<td>1,020</td>
<td>1,081</td>
<td>1,146</td>
<td>1,186</td>
<td>1,228</td>
</tr>
<tr>
<td>Pigs</td>
<td>1,625</td>
<td>1,674</td>
<td>1,724</td>
<td>1,772</td>
<td>1,813</td>
</tr>
<tr>
<td>Poultry</td>
<td>10,091</td>
<td>10,697</td>
<td>11,338</td>
<td>11,656</td>
<td>11,947</td>
</tr>
<tr>
<td>Gouts &amp; Sheep</td>
<td>126</td>
<td>142</td>
<td>153</td>
<td>159</td>
<td>165</td>
</tr>
</tbody>
</table>

18. Cattle are often used for pulling carts, occasionally for household meat, but mainly raised and sold for cash income. The number of heads per household vary between three and more than fifteen. Buffalo dominates cattle. Buffaloes are used for land cultivation. In lowland area, cattle and buffalo range freely after crop harvest but are confined, often by tethering, during the wet season. Pigs, cattle and poultry are the principal livestock of the upland areas. These are raised
under extensive husbandry systems. Livestock graze on upland fallow, roadsides and waste places and natural grassland areas.

19. Animals are exported alive in part due to the lack of processing facilities, mainly to Thailand (cattle and buffalo) and Vietnam (pigs). There are no official statistics on the extent of this trade. Estimates of the annual export of large ruminants to Thailand run as high as 100,000 heads.

20. Livestock and fisheries have received little attention for funding and animal health systems have limited coverage. Public expenditure for livestock development was 3 percent in 1997.\(^{22}\)

\(^{22}\)Public expenditure in the agricultural sector during 1996-97 was Kip 62.52 billion (equivalent to US$67.9 million). Most of the expenditure was on irrigation development (75 percent), with 10 percent for forestry, 8 percent for research and extension, and 4 percent for crops.