Assessment of Past Reforms

Overall, the reform efforts of the Lao Government from the mid-1980s to 1994 resulted in considerable progress in both systemic transformation and macroeconomic management. The basic elements of a market-oriented economic system are now in place, including (i) a market-based price system; (ii) a small but dynamic private sector; (iii) a two-tier banking system; and (iv) a broadly open foreign trade regime. As for macroeconomic management, the Government succeeded in reducing inflation sharply in the late 1980s and limiting it to a moderate rate in the early 1990s. This success was followed by improved output growth and a strengthened external position.

This is not to say that the reform process was without problems. There were many performance shortfalls: reform measures in the areas of taxation, privatization, and the civil service, as well as the updating of the rolling public investment plan, were not implemented fully as planned. Some delays were also experienced with regard to institution building, notably the establishment of a Treasury with an effective accounting system and the enactment of business and other laws. In some instances (such as privatization and civil service reform), the shortfalls partly reflected the overly ambitious targets in terms of both the scale and speed of reform. In most cases, however, political constraints and institutional and technical weaknesses combined to hamper effective implementation. Furthermore, structural reforms of this type are typically more difficult to achieve, in view of their greater political and social sensitivity and more demanding administrative and technical requirements, than other policy objectives. These factors—rather than any wavering in the authorities’ commitment to the reform process—seemed primarily to account for the slippages in implementation.

Factors Facilitating Reform

The following factors favorably influenced the reform process.

- The Lao authorities’ success in achieving macroeconomic stabilization during 1989–94 owed much to (i) the strong emphasis on demand management and the overall macroeconomic framework that was put in place, even though macroeconomic management lacked many of the indirect tools conventionally employed in a market economy; and (ii) the promptness with which the anti-inflationary policies were undertaken.
- The Lao economy was dominated by agriculture, not by industrial state-owned enterprises. These conditions facilitated the supply response to structural reforms and limited the possible adverse impact of state enterprise reform.
- Unlike other members of the former CMEA, the Lao P.D.R. did not have very extensive economic ties with the former Soviet Union. The country could therefore withstand the external shock during 1990–91 from the loss of aid (equivalent to about 4 percent of GDP) from the former Soviet Union and the loss of preferential trading arrangements with the countries of the former CMEA during 1990–91. Even so, some adverse impact would still have resulted from the shock were it not for two additional factors. First, the structural reform program had been introduced before Soviet aid was cut. Second, this aid cut was more than compensated for by a large increase in assistance from other bilateral and multilateral sources.
- Central planning was not deeply entrenched in the Lao economy. Because central planning had been introduced only in 1975 and even then in a hesitant and somewhat ad hoc manner, collectivization and centralization did not fully take hold. Indeed, there remained a strong market legacy, which enhanced the effectiveness of subsequent market-based reforms.
- The decision to introduce reforms resulted from an early recognition by the leadership that central planning was proving unsuccessful. This recognition was reinforced by the demonstration effect of the rapidly growing, market-oriented economies of East Asia.
• The Lao P.D.R. had normal financial and commercial relations with the international community from the outset of the reform process; in particular, multilateral organizations provided substantial technical assistance to facilitate the reform process.

Factors That Complicated Reform

The following factors unfavorably influenced the reform process.

• The institutional and administrative structure for implementing reforms was extremely weak and characterized by a lack of skilled workers, owing to the heavy loss of life in wars from the mid-1950s to the mid-1970s and to the exodus of educated persons and entrepreneurs with the advent of socialism. This weak structure limited the absorptive capacity of the economy, as was evidenced in the delays in both the effective execution of aid-financed projects and the utilization of technical assistance.

• The lack of modern tools of indirect macroeconomic management in the late 1980s led to temporary financial policy slippages soon after the reforms were introduced.

• The extremely limited statistical data base severely constrained the authorities’ ability to monitor and analyze economic developments, and thus formulate policies.

• Certain reforms, such as privatization and civil service reform, were delayed because of their political and social sensitivity. Budget constraints limiting the scope for provision of a social safety net exacerbated the situation.

Future Challenges

Despite the progress made in the past several years, the Lao P.D.R. still faces serious challenges in conducting macroeconomic management and making further structural reforms.

In particular, much still needs to be done in the area of structural reform. First, financial sector reform requires strengthened banking supervision and prudential regulations, increased competition, and improved management of commercial banks. Second, fiscal reform calls for an improvement in the structure of expenditure, particularly the prioritization of a rolling medium-term public investment plan—for example, through a core program—and the synchronization of this program with the annual budget. Third, civil service reform entails the identification, retrenchment, relocation, and redeployment of redundant workers, as well as the introduction of a civil service examination. Fourth, the legal framework has to be strengthened in many areas, particularly those related to business activities. Fifth, land reform requires the issuance of land-use rights. Sixth, the trade and tariff system needs to be further rationalized, and the administrative capacity to implement the system needs to be strengthened. All of these actions are essential to increase the economy’s growth potential and to improve the standards of living for current and future generations in the Lao P.D.R.

Finally, it is necessary to recognize that further progress in structural reforms, particularly those identified above, requires macroeconomic stability. Moreover, such progress calls for the authorities’ sustained determination, as well as for support from the international community.

Postscript

Following the Government’s reasonable success in establishing financial stability during 1989–94, macroeconomic performance deteriorated in 1995. Monetary and fiscal policies loosened. In the monetary area, the authorities pursued lax credit policy to boost private sector activity, which contributed to increases in the growth of domestic credit and broad money to annual rates of 61 percent and 39 percent, respectively, in early 1995. In the fiscal area, budgetary operations became problematic during the first half of the fiscal year. There were some overruns in current expenditure—on wages, materials, and transfers—while the collection of timber royalties fell seriously behind schedule.

These lax financial policies, together with a liberalization of imports, increased demand pressures. Consumer prices rose by some 14 percent (adjusted for seasonal factors) during the first half of the year, partly reflecting a substantial increase in food prices. Meanwhile, strong import demand exerted increasing pressures on the exchange market.

Initially, the authorities responded to these exchange rate pressures by selling reserves, depreciating the official rate by a small amount, and applying administrative controls, including limitations on the allocation of foreign exchange by commercial banks and on the activities of the exchange bureaus. These controls gave rise to exchange restrictions but did not solve the fundamental problems.

In mid-1995, the authorities decided to adopt a comprehensive policy package to put the economic program back on track for the remainder of the year. The central bank started to tighten monetary policy through direct and indirect instruments. As a result, monetary growth started to slow down; it is estimated to have declined to about 24 percent by the
end of December. Likewise, domestic credit expansion fell significantly to an estimated rate of 25 percent by the end of 1995. Mainly as a result of monetary tightening, interest rates on auctioned treasury bills and loans rose over the same period to the 28–30 percent range and turned positive in real terms.

In the fiscal area, a set of measures—yielding a budget deficit reduction equivalent to about 3/4 of 1 percent of GDP—was also adopted in June 1995 to correct the deteriorating fiscal position. Revenue measures included a strengthening of collection procedures for timber royalties aimed at recovering payments arrears from the first half of the fiscal year and securing timely collection in the second half, as well as actions in other tax categories. On the expenditure side, despite higher inflation, the Government cut selected current outlays (mainly for materials and transfers), as well as low-priority capital expenditures. As a result, the current surplus target (1/2 of 1 percent of GDP) for 1994/95 was achieved, and the overall deficit (after grants) was about 4 1/2 percent of GDP, below the target.

In the external sector, the central bank adopted a floating exchange rate system in September 1995 after a period of exchange restrictions and successive devaluations. Since then, the market-based exchange rate has been stable.

The tightening of financial policies and the adoption of a floating exchange rate system in the second half of 1995 contributed to a reduction in aggregate demand pressures. Consumer price increases slowed markedly to an annualized rate of about 10 percent during the fourth quarter of the year; for the year as a whole, however, inflation increased to about 19 percent from about 7 percent in 1994. Output growth maintained its recent trend and was estimated at about 7 percent in 1995, primarily supported by buoyant private sector activity. The current account deficit (excluding grants) in relation to GDP narrowed marginally to about 12 percent, but the overall surplus was substantially smaller than targeted for 1995. Gross official reserves rose somewhat to the equivalent of about two months of imports at the end of 1995.

Progress in structural reforms slowed in early 1995, but the reform process accelerated later in the year. Following the establishment of a civil service monitoring unit in mid-1995, the authorities began to develop a computerized system for monitoring the retrenchment program, with assistance from the World Bank. Progress in other areas of structural reform included the extension of treasury bill auctions to the nonbank public; the removal of interest rate ceilings on loans (except those on certain loans to the agricultural sector); the further rationalization of the tariff system; the adoption of a new rolling medium-term public investment program; the announcement of a list of strategic enterprises to be retained in the public sector; and some improvement in the compilation of the economic database.

The policy slippages and the resultant deterioration in macroeconomic performance in 1995 clearly magnify the challenges that the Lao authorities will be facing in future economic management. This most recent experience seems to demonstrate that a prudent financial policy stance needs to be maintained while pursuing growth objectives and deepening structural reform. In the context of monitoring and analyzing economic developments and formulating an appropriate policy agenda, the Government also faces the challenge of making speedy progress in compiling economic statistics and improving their quality.