THE AUSTRALIAN NATIONAL UNIVERSITY

Working Papers in Trade and Development

Tiny, Poor, Landlocked, Indebted, but Growing: Lessons for Late Reforming Transition Economies from Laos

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February 2010
Working Paper No. 2010/03

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TINY, POOR, LANDLOCKED, INDEBTED, BUT GROWING: LESSONS FOR LATE REFORMING TRANSITION ECONOMIES FROM LAOS

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Abstract:

There are few countries where 'initial conditions' are as unfavourable as those of Laos. It is a very poor, least developed country. It is landlocked, sharing its international borders with five neighbours. It has the world's highest per capita stock of unexploded ordinance, a legacy of the Indo China war. It has yet to recover from the loss of most of its entrepreneurial class and over half of its tertiary educated population in the aftermath of that war. It is heavily indebted, with substantial Soviet era obligations still outstanding. Its institutions are weak and property rights ill defined. Yet, its reform efforts over the past two decades have been largely successful, with accelerating growth and the beginnings of a relatively smooth transition from plan to market. Our examination of the Lao reform program and the subsequent outcomes suggests that, contrary to some of the prevailing pessimism, late-comers can engage with the international economy, providing their reforms are reasonably effective and credible. Neighbourhood effects have obviously been supportive in the Lao case, but their importance should not be over-stated.

Key words: Laos, latecomers, economic reform, plan to market, transition economies, landlocked states

JEL codes: O53, P30

(1) INTRODUCTION

The principal international development challenges lie with the very poor, the 'bottom billion' (in the words of Collier, 2007) who reside mainly in the poorest countries, especially the 'least developed' group. These are countries that suffer acutely not only from very low material welfare but also from a number of other handicaps, including geographic isolation, conflict, endemic disease, embedded institutional weaknesses and political instability. Although the cross-country growth econometrics literature is predicated on the notion of convergence (ie, catch up), in practice relatively few countries have been able to successfully graduate from very low levels of per capita income.

According to this prevailing international pessimism, particularly evident in the literature on Africa, a sustained acceleration in economic growth rates is difficult to achieve, and economic policy reform may generate little if any socio-economic dividends for these 'late-comers'. Aside from inherent development obstacles, the international economic and political climate is also said to be inimical to development. Poor countries opening up to the global economy will by definition specialize in the production for export of unskilled labour and natural resource-intensive products. Yet, it is alleged, there are substantial barriers to the successful penetration of these markets.

Other factors are also said to act as barriers to latecomer reformers. Global manufacturing networks are restricted to those participants with the requisite minimum standards of human capital, physical infrastructure, scale, respect for property rights, and policy reform credibility. Moreover, with so many developing countries attempting to reform and enter these markets, competition is intense and only the most sure-footed reformers are able to succeed. In addition, foreign investors with abundant location options are able to extract lucrative fiscal incentives from host countries, with the option of easy exit upon expiry of these facilities. In agriculture, OECD markets remain restrictive, as further underlined by the failure of the Doha Development Round of trade negotiations. Mineral-rich economies are subject to the vagaries of the well known 'resource curse' (Sachs and Warner, 2001). Also, there are said to be broader, systemic barriers to development. One is the limited 'policy space' imposed by international organizations such as the IMF and the WTO, reinforced by bilateral donors. Another is the increasing loss, both temporary and permanent, of high-levels skills, as rich countries adjust to the demographics of a rapidly ageing population. These challenges are regarded as all the more daunting in the case of economies attempting to navigate the transition from a socialist, centrally planned economy to a market-oriented one (Pomfret, 2002).

While these barriers are no doubt relevant, it is important that they not be overstated and thereby become the basis for a new development orthodoxy. The purpose of this paper is to argue, on the basis of a detailed study of one of the world's most disadvantaged least developed countries, the Lao People's Democratic Republic (Lao PDR, hereafter Laos), that late-comer reformers can successfully engage with the global economy, in the process achieving moderately high growth rates and improved living standards.

Inevitably, each country has particular and specific circumstances that shape its development trajectory. However, we argue that the lessons from the Lao experience have general applicability, and that they generate at least as many insights for policy reform as, for example, an econometric analysis of the growth determinants of 100 countries over 30 years.

It is difficult to imagine a country with more unfavourable ‘initial conditions’ than Laos, a country included in Collier’s (2007, p.7) collection of countries still in one of the ‘development traps’ of conflict, natural resource abundance, land-locked or with poor quality governance. It is a tiny economy with a GDP of $5 billion. The legacy of 60 years of colonial neglect and more than a decade of vicious conflict resulted in it being one of the poorest countries in the world in 1975, when it then turned communist. About three-quarters of its small educated elite, comprising its entrepreneurial class and senior policy makers, fled the country, were killed, or imprisoned. Thirty years later, only 14% of its population had completed primary education. It had (and still has) the world’s highest stock of unexploded ordnance per capita. It has been caught up in great power rivalry. For over two decades from the 1970s, it was isolated from the global economy, yet it emerged from this period highly indebted, mainly to the former USSR. Following another large neighbour, Vietnam, in the mid 1970s it embarked on a disastrous decade of central planning, agricultural collectivization and hostility to the private sector.

In the mid 1980s the Lao government embarked on a cautious program of reform and liberalization. The reforms were largely conventional in nature. They included (a) price decontrol; (b) the removal of many domestic and international trade barriers; (c) the adoption of a unified and, over time, market-conforming exchange rate; (d) the gradual removal of restrictions on private enterprise, including later foreign investment; and (e) reform of the bureaucracy and the state enterprise sector. The results have been increased and reasonably stable rates of economic growth, a more than doubling of per capita income over the past 20 years, and marked improvements in all social indicators. We therefore conclude that the Lao experience cautions against unwarranted pessimism concerning the development prospects of the world’s poorest nations. ‘Orthodox’ policy prescriptions can work and lift countries out of dire poverty. Of course, this is a slow and complex process, and admittedly Laos had some advantages, principally its proximity to some high-growth reform success stories such as Vietnam, and the absence of serious conflict over the reform period. Nevertheless, every country will arguably possess at least some positive attributes, while the Lao handicaps have arguably been among the most formidable in the developing world. Moreover, favourable location is no guarantee of development success, as the record of its neighbour Burma illustrates.

It is important to emphasize that the Lao reforms have been incremental and gradual rather than ‘big bang’ in nature. According to Chauvet and Collier’s (2008) survey of reform in ‘failing states’, it was one of the 26 countries to exhibit ‘no sustained reform’ over the period 1977-2004, compared to 25 who implemented sustained reform. This conclusion, developed on the basis of the World Bank’s Country Policy and Institutional Assessment criteria, may appear harsh. But it is based on a standard methodology, developed on the basis of 20 components (covering economic management, structural polices, social inclusion, public sector management and institutions) that are rated on a 1-6 scale.

Our organization is as follows. Section 2 provides an overview of the Lao development record, the political context and social progress. The following three sections examine the reforms and development outcomes in detail. We focus on the transition from plan to market; high aid dependence and a concomitant multiplicity of donors and diverse modalities and priorities; and the country's unusual mix of major foreign exchange earners, principally electricity, remittances, mining, tourism and garments. Section 3 focuses on macroeconomic and exchange rate policy, section 4 on trade policy, and section 5 on microeconomic and enterprise reform. Section 6 presents our conclusions and draws out some broader implications for development policy in late-reforming countries.

(2) AN OVERVIEW: THE LAO DEVELOPMENT RECORD

(2.1) The Historical Backdrop

Lao history is dominated by foreign intrusion.[1] It was first formally united as a quasi nation state when it became part of the French Indo China colonial empire from the 1890s, governed from Hanoi and largely neglected. Physical infrastructure was rudimentary and education limited to a tiny Francophile elite. Following the Japanese occupation and a period of armed conflict, the Kingdom of Laos became an independent nation state in 1953, governed as a constitutional monarchy. It embarked on an ambitious development program, with significant foreign aid, mostly from the US. From 1960 it became heavily enmeshed in the American war effort in Vietnam.

In May 1975, following the communist victory in Vietnam and the cessation of war, Laos became formally known as the Lao PDR. The Indo China War left a terrible legacy. Although the transition to communism was more peaceful than in either Cambodia or Vietnam, it is estimated that the country lost about three-quarters of its educated population, who either fled as refugees, the most common option, or were imprisoned in remote re-education camps. Many of the latter perished. The aftermath of the War had horrific human consequences. The country had been extensively bombed, particularly the bordering area around the Ho Chi Minh trail,[2] such that one-third of a century later the country is estimated to have the highest incidence of unexploded ordnance per capita in the world.

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[1] The most comprehensive English-language history of Laos is provided by Stuart-Fox (1997).

[2] Over the period 1962-1975, more than 2 million tons of ordnance was dropped on the country, of which an estimated one-third did not detonate. Nine out of the country's 17 provinces outside the capital are still affected, and thousands of mine-related injuries occur each year.

Like its neighbours, particularly Vietnam to which it has always been closely linked,[3] the communist regime introduced central planning, nationalized all major enterprises, and attempted to introduce agricultural collectivization. Trade with the western world, including non-communist Southeast Asia, virtually disappeared, and Laos formally joined the Comecon Bloc. The then USSR and other East European states became the regime's principal diplomatic and commercial sponsors. Predictably the economy contracted during this first decade, although there are no reliable economic statistics.

Faced with declining living standards, mass poverty and the imminent implosion of the USSR, the Lao leadership began to follow Vietnam down the road of cautious economic reform from the mid 1980s.[4] Vietnam's 'Doi Moi' (literally 'Renovation') was replicated in Laos under the banner of the so-called 'New Economic Mechanism', NEM. Laos also began to cautiously re-open diplomatic relations with the non-communist Southeast Asian states, although it would be another decade before it formally joined ASEAN, the Association of Southeast Asian Nations, in 1996.

Under the NEM, reform has been gradual and reasonably consistent, with three broad episodes apparent. In the first and most important phase, approximately 1987-94, most domestic trade barriers were relaxed, almost immediately, private companies were permitted to trade domestically and internationally, and much of the transport sector was opened up to the private sector. In June 1987, the government removed price controls, except for utilities, public services and several 'strategic' products (eg, cement and steel). It also permitted some trade to be conducted at exchange rates closer to the informal market, leading to the unification of the multiple exchange rates in January 1988. SOE reform commenced, but with little privatization. In October 1988, the government began to divest the commercial banking functions from the State Bank of Lao PDR. Tax reforms were introduced in the 1988 budget. Civil service salaries were increased and staff numbers reduced. Large aid flows from the West resumed, and these in turn enabled the country to run very large current account and fiscal deficits.

In the second phase, 1995-99, trade reform continued and there was the beginnings of SOE reform. The reforms were then stalled by the inter-related events of serious macroeconomic problems and the East Asian economic crisis. There was a temporary loss of macroeconomic control, a brief period of hyperinflation, and a large nominal exchange rate depreciation. The severe contraction and exchange rate collapse in several neighbouring countries in 1997-98 also put the reform momentum on hold. A third phase has been evident since 2000, with the restoration of macroeconomic stability, continuing gradual reforms, and the emergence of two significant natural resource booms.

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[3] It should be noted, however, that the closest ethnic-linguistic links are to Thailand, with the Lao and Thai languages being mutually understandable.

[4] There is no comprehensive analysis of Lao economic development from independence to the present day. Bourdet (2000) and Than and Tan (eds, 1997) provide detailed accounts for the period up to the late 1990s, mainly focusing on the first decade of the NEM. The ADB, IMF and World Bank issue periodic reports and updates.

Nevertheless, and unlike Cambodia, there has been very little political reform. Laos remains a single-party state, under the control of the Politburo of the Lao People's Revolutionary Party, the LPRP, which exercises its authority formally through the country's National Assembly. Senior officials are required to be members of the LPRP, which perpetuates itself through a mixture of authoritarian rule and patronage. The media is heavily controlled and civil society largely absent. Ethnic minorities, mainly living in the border regions, are often suppressed. There has been some decentralization of political authority, introduced in the late 1980s as part of the NEM. Power was devolved to the provinces rather than villages, and recognized the strong regional sentiments in the country's three main regions, the north, centre and south. Initially, significant revenue sources, including external trade and several taxes, were devolved to the regions. As local service provision became more uneven from the late 1990s, however, the central government attempted to re-centralize its fiscal powers, particularly under the budget law of 2006.

(2.2) Economic Recovery and Growth

Laos is one of the poorest countries in Southeast Asia, with a very low GDP per capita and Human Development Index (HDI) ranking.[5] However, since 1990, when rudimentary but plausible national accounts have been prepared, its economy has grown on average at about 6% per annum, somewhat slower than Vietnam and less erratically than Thailand (Figure 1). With population growth of about 2%, this implies an annual per capita growth rate of 4%, and per capita income more than doubling since the reforms commenced. This is the first period of sustained growth in the country's recorded history. The economy slowed in the wake of the 1997-98 Asian economic crisis but growth remained positive. Unlike the crisis-affected economies, there was no financial contagion since Laos was then still a mainly agrarian economy, little connected to global financial markets, and with little short-term external debt. The crisis impacted mainly through the real sector effects of declining export demand, particularly as Lao trade patterns were heavily concentrated within East Asia, in part a result of the continuing US trade blockade established in 1975.

(Figure 1 about here)

The process of economic growth has resulted in steady structural change since 1990 (Figure 2). Most sectors of the economy have performed well. Agricultural growth has averaged slightly more than 4% per annum, mainly through increased crop yields; crops, mainly rice, constitute 58% of agricultural output. There has also been some diversification into maize, fruit and vegetables. The irrigation and road networks have been expanded, thus

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[5] Among the four low-income mainland Southeast Asian states, its 2008 per capita GDP was estimated to be $837, compared to $651 and $1,052 for Cambodia and Vietnam respectively. No plausible estimates for Burma are available. In HDI rankings, Laos is number 130, very similar to two of its neighbours Cambodia (131), Burma (132) but lower than Vietnam (105).

raising yields and lowering marketing costs. Barriers to inter-provincial trade have also been relaxed, and there is less emphasis on local food self-sufficiency.

(Figure 2 about here)

Industrial output has grown rapidly since 1990. The largest sector, manufacturing, has averaged 12% growth per annum, more than doubling its share of GDP to 20%. Food and beverages constitute 75% of this output, while garments are the major manufactured export. Electricity production has averaged 11% growth, and its share has also doubled. About 97% of power generation capacity is hydro, mostly for export, a point to which we return shortly. Mining output has grown very rapidly, by 25% per annum from a small base. Most of the increase has occurred since 2003, when the major Sepon copper and gold mine commenced production. Services output has grown at an average annual rate of 6.6% since 1990, marginally faster than the economy as a whole. The increases have been broad based: domestic and international trade flows have been liberalized, while transport and communications have grown quickly, with tourism a major source of growth.

There are three main features of the country's external accounts, and these in turn reflect both major policy changes and some unusual, country-specific factors. First, there has been rapid growth of all forms of international transactions in response to the more liberal policy regimes. Over the period 1990-2006, for example, foreign trade as a percentage of GDP more than doubled, from 37% to 78%.[6] This trade growth has been driven by both policy reform and increased exploitation of the country's natural resources.

Second, the country continues to run large balance of trade, current account and fiscal deficits, mainly financed by foreign investment and aid. Excluding official transfers, Lao current account deficits in the past decade have been in the range 10-20% of GDP. Several factors explain this unusually high figure. There is a large merchandise trade deficit, usually 10-15% of GDP, with imports at least 50% more than exports, and sometimes double. Net foreign income is also a large negative item, mainly in the form of income accruing to foreign investment in the country and interest on private external debt. This deficit is financed by large capital transfers, in the form of foreign investment, long-term loans and grants, and private transfers, much of it remittances. Annual foreign aid flows are large, in the range 6-10% of GDP. Reflecting Laos's least developed country status, most aid is highly concessional. Grants constitute 30-40% of the total, with the remainder being low interest loans. As a consequence of this high aid dependence and recent foreign borrowings, Laos is a highly indebted country. External debt is equivalent to 92% of GDP. However, three-quarters of this debt is public, and almost all of it is long-term, low interest borrowings from the international financial organizations, principally the Asian Development Bank and the World Bank.[7]

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[6] Note that these figures exclude the extensive unofficial border trade, mainly with Thailand.

[7] Commercial debt constitutes just 6% of total public debt. One historical curiosum is that most of the 20% of public debt that is bilateral, ie, owed to other governments, is with the Russian Federation, and was mainly

Third, for such a small economy, foreign exchange earnings are moderately diversified, a factor that augurs well for the durability of future growth prospects. Apart from aid and investment, there are several sizable revenue flows. Annual receipts from garments and tourism now each exceed $150 million in most years. Remittances are poorly documented, but are estimated to be about $100 million per annum, from the approximately 5% of the population working either full time or intermittently in Thailand. This mobility is facilitated by a long and porous international boundary, slight ethno-linguistic differences, and unskilled wage differentials of at least 4:1. Copper, gold, timber and other natural resource exports now exceed $100 million per year. Finally, electricity exports have risen rapidly, and now also exceed $100 million.

The mining and electricity exports have originated from a few very large investments. Garments and tourism are by contrast more labour-intensive and the benefits more widely diffused through the workforce. As Figures 3 and 4 demonstrate, growth has been rapid in both, especially tourism. Arrivals have risen by 45% per annum since 1990, from a very low base. The neighbourhood is the dominant source, with Thailand and Vietnam accounting for 55% and 15% respectively. Although small, garment exports began to rise quickly from the early 1990s, boosted by special market access arrangements under the then Multi Fibre Agreement, especially to the European market (Rasiah, 2009). Several foreign firms have relocated from Thailand, to take advantage of export quotas and lower wages. That dependence on Thailand resulted in a downturn in exports in 1997-98, but growth then resumed until affected by the 2008-09 global recession.

(Figures 3 & 4 about here)

(2.3) Social Progress

Lao social indicators have broadly tracked its economic progress. Poverty incidence has fallen substantially, and non-monetary social indicators have improved quickly. The social record has been facilitated by the country's low inequality, a reflection primarily of extensive subsistence agriculture and the absence of large private land-holdings, with the few holdings of any size nationalized after 1975. However, the presence of ethnic minorities, that are socially, geographically, and politically isolated, has highlighted the difficulties of overcoming hard-core poverty.

Table 1 summarizes key social indicators over the reform period, when these data first became available. There have been three rounds of the Lao Expenditure and Consumption Survey (LECS), covering the years 1992/93, 1997/98 and 2002/03.[8] There have also been population censuses and surveys that generate data on education and health indicators. The poverty

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contracted in the 1980s. The figure is thought to be vastly inflated by conversion at the unrealistic official exchange rate that prevailed under the USSR. It is thought unlikely that it will ever be repaid.

[8] The results for the fourth round are expected shortly.

estimates for the 1990s are very approximate, and those for 1997/98 also occurred in the midst of a period of major hyperinflation and slower growth.

(Table 1 about here)

A very useful set of poverty estimates is contained in ADB (2008), based on a common PPP poverty line of $1.35 per day in 2005 prices, and adjusted for the particular basket of goods and services consumed by the poor in each country, together with their prices. The series has the advantage of international comparability among the 13 Asian developing countries. We therefore use these estimates in preference to the county statistics. Two head count estimates are presented in Table 1, based on different prices series, the so-called ‘consumption PPP’ and the ‘poverty survey PPP’. The results are very similar: from 1992/93 to 2002/03, the percentage of the Lao population below the poverty line fell from 72.3-76.6% to 48.8-53.6% (see ibid, Table 6.1, p. 36). This was equivalent to an annual average reduction in poverty of 2.1 percentage points, a decline that was fast even by Asian standards. Among the 13-country sample, only Vietnam and Mongolia achieved faster reductions. Since Lao growth rates over this period were respectable but not stellar, the implied poverty-growth elasticity was high.

The incidence of poverty is unevenly distributed both spatially and among ethnic groups. Ethnic minorities constitute about three-quarters of the households in poverty. As Engvall (2006) shows, in 2002-03 the poverty incidence was well below the national average for the dominant Lao-Tai group (at 28.7%), but it was higher for the other 48 ethnic minority groupings. Poverty is also much less serious in urban areas, with the capital, Vientiane municipality, having a figure of 20.2%. The uneven progress with poverty reduction is illustrated by the fact that poverty severity actually rose for some of the period in Oudomxay and Bokeo provinces, both located in the isolated, mountainous north-west of the country. Engvall (2006) also concludes that it is not ethnicity per se that determines poverty incidence, but rather the characteristics associated with it. Thus, in an analysis of the determinants of poverty in 6,474 households from all 18 provinces, unequal access to resources (land, infrastructure, education) and household demographic characteristics (number of adults, family size) are identified as the key variables.[9]

Laos also lags in other social indicators, with as noted a very low HDI ranking. Nevertheless, non-monetary social indicators have improved quite quickly since the reforms commenced (Table 1), and the country is on target to meet its income poverty Millennium Development Goals by 2015. Life expectancy at birth has increased by a decade since 1990, while the infant mortality rate has almost halved. Literacy and primary school enrolments have risen significantly, as has access to water supplies. Nutritional intake is substantially higher, reflecting both higher rice production, improved transport

[9] See also the analysis by Rigg (2005) of poverty and living conditions in nine villages located in three of the most prosperous provinces during 2001 and 2002.

infrastructure,[10] reduced barriers to domestic trade, and greater opportunities for internal and international migration. These improvements suggest that public social expenditure strategies have been reasonably effective and targeted, except perhaps for the special case of the ethnic minorities.

With these developments as background, we now examine the Lao reform process and outcomes in more detail. We focus on three key areas of economic development and policy, in the context of the transition from plan to market since the 1980s. These are macroeconomic management and exchange rate policy; trade policy; and microeconomic reform, the latter including the SOE sector, the investment climate and the banking sector.

(3) MACROECONOMIC MANAGEMENT

(3.1) Fiscal policy

As in all transition economies, macroeconomic management has been a major challenge, complicated by high external indebtedness, and a weak revenue base, with a non-resource tax revenue/GDP ratio of 10%, low even by least-developed country standards. This has resulted in very large aid dependence: for the decade 2000-10, donors contributed about 61% of government's capital budget and 39% of total government expenditure, equivalent to 7.6% of GDP. The SOE sector is only partially reformed, parts of it operate with a quasi-soft budget constraint, and contingent liabilities are substantial. The banking sector in particular remains largely in state hands, while prudential supervision and governance is limited, an issue to which we return below. The country's terms of trade are occasionally volatile, and with it government revenue. Over the past decade a significant 'booming sector' has emerged from electricity and mining exports. Moreover, as a result of past episodes of hyperinflation there is also little trust in the country's currency, resulting in widespread reliance on foreign currencies.

Three specific problems, common to many transition economies, have frustrated the government's efforts to increase tax revenues (see Valdivieso et al, 2007). First, there is fragmented revenue administration. The provinces have responsibility for collecting major taxes, but they have little incentive to collect revenues in excess of their spending needs, as these funds accrue to the central government. Moreover the fragmentation of the administration of major taxes is inherently inefficient. While many countries have decentralized authority over expenditure, most countries have retained a centralized tax administration. Second, the proliferation of tax incentives to attract investment in a partially reformed economy has eroded the income tax base.[11] Third, there has been persistently weak tax administration. The tax office itself is under-resourced, corruption remains a serious problem, and trade

[10] See Menon and Warr (2008) on the link between the provision of transport infrastructure and poverty reduction in Laos.

[11] More than 1,600 firms enjoy generous fiscal incentives under the investment laws. Moreover, these incentives appear to be tailor-made for firms and non-transparent in their allocation.

liberalization in the absence of a comprehensive value added tax has reduced revenues.

Nevertheless, although still precarious, there has been significant progress during the transition period, and macroeconomic management has become increasingly effective. The government has begun to consolidate its fiscal accounts, to increase and diversify its revenue sources, to develop a medium term fiscal management framework, and to develop a more decentralized structure of governance. Significant mining royalties are beginning to flow to the government. The incentives to encourage provinces to pass on greater revenues to the central government are being improved, and the 2006 Budget Law has sought to redirect some tax revenues back to the central government. As a result of these measures, non-resource tax revenues have increased by about two percentage points of GDP since 2005.

Despite these improvements, the fiscal position of the government remains vulnerable to external and domestic shocks, and to the domestic perception of abundant natural resource flows. The overall budget deficit has declined continuously, from about 5% of GDP in the early 2000's to 2-3% in 2008 (Figure 5). However, the non-resource budget (that is, net of natural resource revenue flows) has remained high, at about 5-6% of GDP, indicating that a substantial proportion of these revenues are being spent. An increasing share of this expenditure has been allocated to non-discretionary items such as public sector salaries. Fortunately, the global financial crisis has reminded the government of the volatility of resource revenues and its impact on the budget.

(Figure 5 about here)

In the case of the current account, deficits continue to be very large, averaging around 12% of GDP over the past decade. However, they are funded mainly by long term sources, principally aid and foreign direct investment, and the former's share of this funding has been declining. They therefore present no immediate financing challenges

(3.2) Inflation and exchange rate policy

Transition economies are inflation prone: they typically possess a large SOE sector, much of which may operate under a soft budget constraint, with the resulting fiscal deficits being monetized. Controlling inflation to single digits has indeed been a major challenge for Laos. The country experienced hyperinflation in 1998 and 1999 with prices rising by more than 200% over the two-year period (Figure 6). Inflation fell to 23% in 2000 and since then the central bank, Bank of Lao PDR, has generally managed to keep inflation close to or less than 10%, except in 2003 and again in 2008. Both cost-push factors and excessive money supply growth explain these years of higher inflation. For example, a drought in 2003 pushed food prices up, with overall inflation hitting 15%, while in 2008 it was the global increase in food prices, which have a high weighting in the Lao CPI. The rapid expansion of local currency, the kip, in circulation in 1998 and 1999 to develop the public irrigation system, funded mainly by a larger fiscal deficit, contributed to hyperinflation in those two years.

(Figure 6 about here)

Lao exchange rate and monetary policy settings are unusual, even for a transition economy. The central bank runs a heavily managed exchange rate regime, essentially targeting a stable rate against the Thai baht in the absence of major external shocks or sudden fiscal expansions. In earlier years, a stable kip/$ rate was sometimes targeted. The quasi-constant exchange rate serves as the main monetary policy anchor. It also means that, given the large informal capital account transactions, the central bank is unable to control money supply. There is a large unregulated foreign exchange market known as the parallel market. During the 1998-99 crisis, the official and parallel market rates diverged significantly, but in recent years the rates have been practically identical. This is in part due to the removal of restrictions on current account transactions in recent years.

There is widespread use of foreign currencies in Laos, as both a store of value and a medium of exchange. The US dollar and the Thai baht are the most common, in addition to the Vietnamese dong and Chinese yuan in border regions. There are no precise estimates of dollars and baht in circulation, but it is likely that the kip constitutes about 50% of notes in circulation, while about 60% of bank deposits are held in dollars and baht (Menon, 2008). The latter share typically rises during periods of macroeconomic uncertainty such as the late 1990s. Unlike neighbouring Cambodia, political uncertainty has been an unimportant factor in the fluctuations.

The rapid expansion in kip money supply in 1998 and 1999 triggered firms and households to switch cash holdings from kip to US dollars and baht in anticipation of higher domestic inflation and kip depreciation. This underlines the fact that the pass-through of growth in kip money supply to inflation and exchange rate depreciation occurs quickly. The authorities continue to display ambivalence towards the widespread use of foreign currencies. They occasionally try to assert greater control over money supply by encouraging firms to transact in kip only. This includes issuing notices to firms to transact in kip, while at the same time building confidence in its use. But these attempts have been counterproductive, resulting in a rapid flight out of kip and a sharp nominal depreciation.[12] Thus, there is a pragmatic recognition of the reality, that there are also significant benefits for a very small, open economy to have multiple currencies in circulation. The baht and dollar provide a stable nominal anchor in the economy, as well as some monetary discipline, the latter illustrated by the experience of the 1998 and 1999 hyperinflation

[12] For example, in June 1997, with the onset of the Asian financial crisis, the central bank attempted to enforce a September 1990 decree that only the kip could be used as the medium of exchange in all domestic transactions. The result was that, during 1997-98, the kip depreciated more than any other Southeast Asian currency, even though Laos experienced only a mild economic crisis (Menon, 2008).

episode. Moreover, the easy availability of multiple currencies helps lower transaction costs in trade with neighbours.

There is a case for the adoption of a full currency board system given that Laos is just a little larger than the micro economies that typically resort to this option.[13] It would of course result in the loss of both monetary policy autonomy, limited though it is anyway at present, and the proceeds from seigniorage (that is, the difference between the face value of the currency and the cost of producing it). The Lao economic cycle differs from that of both the US and Thailand, whose currencies would be the likely choice. But there would be major savings in terms of transactions convenience and bureaucratic resources (ie, not having to maintain a central bank). The country's flexible labour market would also underpin the effective operation of a currency board, as it facilitates nominal price flexibility. But nationalist sentiment precludes such an option. Thus the de facto approach, adopted also by its two transition-economy neighbours, has been what Menon (2008) terms 'muddling through', recognizing the reality of multiple currencies, and working longer term to build confidence in the local currency.

(3.3) Managing resource booms

Lao macroeconomic management has had to deal with another policy challenge commonly occurring in small transition economies, namely volatile terms of trade and large resource inflows. This instability has arisen from two sources over the past decade, a mining boom and very large infrastructure investments to finance the generation of hydroelectric power for sale to Thailand. Thus the country has faced a 'Dutch disease' of significant proportions, and with a limited array of policy instruments. There is also, more broadly, concern about a possible 'resource curse', as identified by Sachs and Warner (2001): weakening the imperative to invest in education, increased corruption, adventurous borrowing programs, and poor fiscal effort.

Laos is a resource-rich economy with more than 570 mineral deposits identified.[14] Mining production on a significant scale commenced in 2003, in response to high commodity prices and a more open policy towards foreign investment. The net present value of gold and copper exports over the period 2007-20 is estimated to be equivalent of 110% of 2007 GDP. Hydroelectric power capacity has also expanded rapidly, and its exports are of similar magnitude.

These twin booms have contributed about 3% points of GDP growth in recent years, or about one-third of the incremental growth. Natural resources now generate about 15% of total government revenue, and about one-quarter of the real increase in revenue since 2002, thus facilitating a significant reduction in the overall fiscal deficit (Figure 5). In recent years, their impact on the balance of payments has been equivalent to about 5-6% points of GDP. So far, the monetary impacts have been limited, owing to high absorption (mainly

[13] Menon (2008) provides the most detailed analysis of Lao exchange rate policy options.
[14] The figures in this and the next paragraph are from Valdivieso et al (2007).

rising net imports by the non-resource sector) and accumulation of international reserves. Some of the surplus has been monetized, but the inflationary effects have been negligible, partly owing to an appreciating exchange rate, in addition to widespread dollarization anyway. The effects on non-resource exports have been limited, mainly due to the preferential access and generous fiscal treatment enjoyed by garment exports, low and flexible wages, and a substantial tourism industry that is somewhat less exchange rate sensitive. However, these inflationary and exchange rate pressures are likely to intensify in the future.

Our estimates of the Lao real exchange rate[15] indicate that it has remained relatively stable over the past decade (Figure 7). There was a large nominal depreciation at the time of the Asian economic crisis and, even allowing for the brief period of hyperinflation, there was also a real depreciation. For most of the period since 2000 there has been a modest and steady appreciation, to the point that the real rate has now approximately returned to the level a decade ago. Such a trend is consistent with the strengthening terms of trade and structural transformation of the economy discussed above. It also suggests that investments in hydropower and mining have not to date had a major impact on the country's competitiveness. Moreover, the country's real rate has moved closely with those of neighbouring economies, further suggesting that external competitiveness has remained relatively stable. Of course, the measurement of the real exchange rate in a country with multiple currencies in circulation is problematic. But since the kip-baht rate has been broadly stable, and the baht has appreciated against the dollar at about the same real rate as the kip, our general conclusions hold.[16]

(Figure 7 about here)

(4) TRADE POLICY

Trade policy reform is central to the transition from plan to market. It is part of the process of commercial re-engagement and of prices being aligned with those in international markets. The reforms are complex as they entail the mechanics of introducing a formal tariff code and the tariffication of non-tariff barriers. They require equal treatment for SOEs and the nascent private

[15] The real exchange rate is defined here as the nominal exchange rate adjusted for relative changes in the Lao consumer price index and producer prices in the country's major trading partners.

[16] An alternative measure, the ratio of prices of non-tradable goods (proxied by construction and domestic services) to prices of tradable goods (goods that can be exported or imported) shows an increase, indicating that prices of non-tradable goods are rising faster than those of tradable goods. The increase was substantial in the 1990s but modest thereafter. However, these data, not shown here, are at best indicative owing to doubts about the quality of the non-tradable price data. Menon (2008) also shows two real exchange rate series, confirming a modest appreciation since 2000.
See also Warr (2006), who provides a very detailed examination of the potential 'Dutch Disease' effects of a subset of the hydropower investments, through the Nam Theun 2 project.

sector. For very small, landlocked economies such as Laos, there is also the complexity of negotiating through layers of bilateral, regional and multilateral trade agreements, and of access to international transport routes.

(4.1) Trade reform

As noted, under the command economy international trade was a state monopoly, where the level and composition of trade was effectively controlled through quantitative restrictions and state trading companies. Fane (2006) describes the major reforms from the mid 1980s. Initially there was a highly dispersed range of import duties (12 bands, in the range 5-100%). This was subsequently reduced to six bands and a maximum duty of 40%. In 2003, further reforms were introduced, with the simple average MFN tariff reduced to 10%, with the range still 0-40%, and the standard deviation of tariffs falling to 9. Further liberalization is foreshadowed, as part of Laos's application for WTO membership and under its commitments to the ASEAN Free Trade Agreement (AFTA), which we discuss below. In addition to these formal trade measures, given the country's geography, long unpatrolled borders, and a neighbourhood of efficient export-oriented economies, informal trade is thought to be extensive.[17] Prices diverging by much more than 20% of those in neighbouring countries, especially in border zones, quickly induce smuggling.

This appears to be a case of major reform, and it therefore prompts the question as to why the country has been labeled a slow reformer. In practice, the reforms have been incomplete, reflecting the fact that, a quarter of a century after the transition to a market economy commenced, vestiges of the old command system remain. First, non-tariff barriers are still quite extensive. The first set of estimates of effective rates of protection (ERPs) for the country, prepared by the authors (ADB, 2009), show that the reforms have indeed lowered protection, with the average rate about 15%. However, there remain pockets of significant protection, including for the food, beverages and tobacco industry, which has an ERP of over 100% (Table 2). Non-tariff barriers (NTBs) are also restrictive in several sectors, including cement, steel, wood products and several agricultural products. Export taxes continue to be levied on a range of agricultural products. The trade policy regime also discriminates against a number of potentially export-oriented activities, including some agricultural sectors, textiles and garments. The NTBs arise from the country's import management and control system, that classifies imports into prohibited goods, controlled goods, and general goods. Most of the NTBs occur in the second group of goods. Their definition remains arbitrary but they are essentially granted for protectionist reasons, for example, to meet the gap between predicted domestic production and estimated demand.

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[17] It is estimated that informal trade with Thailand constitutes an additional 30% of the officially reported figure, in addition to significant informal trade with China and Vietnam. These figures are unlikely to be affected by either WTO accession or implementation of AFTA. There are also substantial (illegal) sub-national barriers to trade, run by local customs and military offices.

(Table 2 about here)

Moreover, at least until recently, many of these NTBs were not formally announced or directly amenable to measurement. For example, fieldwork by the authors revealed a cartel operating in the cement industry, underpinned by the small number of producers in the industry, the presence of a large SOE, the government's major role as a consumer of cement products (both directly and indirectly), the 'perishable' nature of the product and the concentration of construction activity in the dry season months. In addition, provinces issue NTBs from time to time. While it is difficult to obtain an accurate picture of the prevalence of these NTBs, informal estimates indicate that at least 214 measures on imports exist at the province level.

As in other transition economies, trade reform in Laos is complicated by two additional factors. One is that the responsibility for trade policy is distributed among several agencies, which differ with respect to policy orientation and analytical capacity. Thus, the more reform-minded Ministry of Finance sets tariffs, while the more interventionist line ministries, in particular the Ministry of Industry and Commerce (MOIC), have responsibility for NTBs. Another important consideration is that trade taxes constitute about 20% of the government's revenue. This underlines the importance of continuing the process of converting NTBs into tariffs, and to proceed with the proposed value added tax to compensate for falling revenue as tariffs decline.

Second, effective tariffs (that is, import revenue as a percentage of the value of imports) are just 4.4%, or less than half the simple average. The difference arises due to the wide range of exemptions. These apply to export-oriented firms, to donor-funded programs, and to the import of machinery and raw materials to approved foreign and domestic investors. There are also exemptions under AFTA and of course smuggling. The various duty exemptions are most likely the major distortions. The incentives given to the 1,600 firms under the investment laws are administered in an opaque manner.[18]

There are also administrative complexities in the regulation of international trade, although these are gradually being eliminated as Laos prepares for WTO accession. The government operates an import-export management and control system identical to that in Vietnam until recently. It has two key features. The first is import licensing, in which goods are categorized as prohibited, controlled, or 'general', that is, able to be freely imported. The first category, generally not protectionist in nature, is based on public safety, environmental or moral considerations. The second category refers to imports that are managed by the MOIC. Until October 2006, these included 25 broadly defined items, such as prepared foods, and most raw or semi-manufactured products used in manufacturing. The reform of that month simplified the system considerably so as to be consistent with WTO procedures, including the use of non-automatic and automatic licences. The number of import items subject to non-automatic licences on the controlled list has also been further

[18] The system also introduces a cascading tariff structure where highest rates apply to processed goods and lowest rates to raw materials, resulting in very high levels of effective protection, even with a 40% tariff ceiling.

reduced. Moreover, import administrative procedures have been rationalized significantly, with the removal of both trade officials at customs posts and the requirement that firms provide detailed plans prior to obtaining approval to import.[19]

(4.2) Regional and international agreements

While the major imperative of reform is unilateral liberalization, the reality is that very small transition economies typically have limited space on trade policy issues. Moreover, the institutional and political arrangements governing their trade policy are shaped by several external factors, and these may stretch the analytical and administrative capacity of countries with very weak institutions. The Lao experience provides a good illustration of these propositions.

First, as noted there is the desire to join the international mainstream through membership of the WTO, which for domestic reformers also has the beneficial effect of enabling them to develop formal and unilateral mechanisms for the management of trade policy. However, the negotiations are complex and protracted. For example, in November 2006 the Lao authorities received a list of 159 questions from WTO member countries, and for which the government response took some years. The questions related to such issues as export/import licensing, customs procedures, and the local content and export requirements of the foreign investment regime.[20] Reform in these areas is obviously desirable, but highly demanding for a country with no more than a handful of analytically equipped officials.

Second, when Laos joined ASEAN in 1996, it automatically became a signatory to a range of regional ASEAN initiatives. The most important of these is AFTA, in addition to a plethora of ASEAN agreements with many regions and countries. Membership of ASEAN is obviously desirable for strategic, political and commercial reasons. The Association is durable and influential, while its member economies are mostly dynamic and open. It also provides a buffer against Chinese commercial and political domination. The Lao government sensibly regards AFTA as a useful preparatory mechanism for broader unilateral liberalization and WTO membership. It has therefore

[19] Until the reform, all producers/importers were required to produce an import plan each year for approval by MOIC, whether or not the products were on the controlled or prohibited list. Items imported were deducted against the overall plan at the customs border post. This system was a legacy of the old planned economy, and also of the system of foreign currency rationing. Moreover, even exempted imported inputs for export-oriented firms faced considerable administrative complexities, with these costs bearing disproportionately on small firms owing to the scale economies associated with compliance.

[20] Specific issues that are being addressed as part of the application include rules of origin requirements, valuation methods, and appeal procedures; customs, immigration and quarantine procedures; the turnover tax, which is currently higher for imports than domestically produced goods; and investment promotion, including the provision for licensing conditional upon guaranteed market access.

committed to full membership of AFTA by 2013, by which time its ASEAN rates would be 0-5%, but with provision for a limited number of 'sensitive' exclusions.

The ASEAN commitments do however introduce complications. Partly in response to domestic protectionist pressures, in sectors as diverse as palm oil and telecommunications, the government has announced its intention to run dual track customs policy, for ASEAN and non-ASEAN imports. It is very doubtful that such a strategy is administratively feasible and could be corruption-free. In addition, the AFTA arrangements need to be consistent also with the country's land-locked status, and in particular the facilitation agreements governing transit goods bound for third country markets. Moreover, ASEAN's trade agreements, both internally and with its major trading partners, are administratively complex and time-consuming. The Association has more than 700 meetings each year, many to do with the minutiae of commerce, yet the Lao government has merely a handful of over-stretched staff competent to undertake international commercial negotiations. This is in addition to compliance with various international trade protocols and commitments, ranging from photo-sanitary requirements to 'fair labour' provisions.

A third factor affecting Lao trade policy is that its small size, low income and 'least developed' status mean that effectively most of the country's exports face few very formal trade barriers. Indeed, the country receives an extensive array of special trade access concessions. The principal danger of these arrangements is that they are temporary, in that they may be withdrawn at short notice and the margins of preference (as compared to MFN rates) are generally declining. Yet firms and policy makers may be tempted to make longer-term commercial decisions on the assumption that they are quasi permanent. The optimal strategy is therefore to treat them as a short-term windfall gain, to be employed to productively build longer-term competitiveness.

<u>(4.3) Is being land-locked a problem?</u>

A common assertion in the development economics literature is that being land-locked is a barrier to development. In several cross-country growth econometric estimates, for example, the dummy for land-locked countries is negative and significant. These observations are dominated by African countries, however. In the case of Laos, in spite of its earlier isolation and its sometimes uneasy neighbourhood relations, being land-locked does not appear to be a serious problem.

The explanations have to do with pragmatic border agreements (in which membership of ASEAN has played a positive general role); a neighbourhood dominated by efficient, export-oriented economies; trans-border coordination of logistics and infrastructure provision; and the availability of at least two international options, east and west (Vietnam and Thailand respectively) with good highway-port connections. Laos's first transit trade facilitation agreement was with Thailand. This appears to operate effectively, with a well-established transport corridor from the capital, Vientiane, to Bangkok. Providing the necessary customs protocols are observed, goods generally move quickly and with little difficulty.[21] Subsequently, Laos signed an agreement with Vietnam, for transport along its route 9 to the major Da Nang port. This is now in operation, as is the inclusion of the second city of Laos, Luang Prabang. Owing to major investments in road networks, and the signing of the Cross Border Transit Agreement with Thailand, the cost and time to truck goods has fallen significantly. According to transport industry sources, it now takes four hours to truck goods via the East-West Economic Corridor from the border posts with Thailand and Vietnam. The high cost of the inefficient local truck industry has been partly offset by permitting trucks from neighbouring countries to enter Laos. Discussions are under way with China for a similar cross-border agreement. Civil aviation is also developing rapidly, with Bangkok's dominance as the region's traditional civil aviation hub broadening to include direct flights to neighbouring Cambodia, China and Vietnam, and including both Vientiane and Luang Prabang.

While being land-locked is therefore not a serious obstacle, two principal challenges remain to be overcome. One is that Laos's border infrastructure needs to connect back to the hinterland, particularly so that the country's agricultural and tourism potential may be realized. This requires both better rural infrastructure, particularly roads, and the removal of minor commercial harassment by local police and customs officers. The second is to facilitate the access of smaller newcomer exporters to the trans-border arrangements. The present protocols appear to work satisfactorily for existing large exporters, who have well-established relationships with the customs service and Thai freight-forwarders, and whose scale enables them to employ low-cost containers, which are sealed after the ex-factory customs inspection. However, the system is much more complex for firms whose exports are small or irregular. These firms need to consolidate loads to achieve the lower costs of the large containers. The market for this service remains under-developed, raising costs and delaying shipment. Moreover, customs procedures remain slow and costly for these firms.[22] Ironically, the expensive 'friendship' bridge across the Mekong River linking Laos and Thailand is estimated to have saved only 45 minutes due to these customs complexities. Moreover, the lack of 'consolidation points' along the border adversely affects SME exporters, who therefore face higher fixed costs of trade facilitation.

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[21] For example, a large export-oriented garment factory interviewed by the authors in 2007 reported that container consignments can be transported from the factory to the Bangkok port, and through both countries' customs services, within 24 hours, and at a cost of 20 cents per shirt. As a point of comparison for example, this is very similar to the cost and time for an Indonesian garment exporter in Bandung, the major centre of Indonesia's garment industry, shipping through the Jakarta port.
Note, however, that trans-border shipment of goods from Thailand through Laos to Vietnam and back is virtually impossible, as pointed out in a recent, unpublished report by the freight company TNT.

[22] For example, fieldwork revealed that pre-clearance is required at the entry point and original copies must be sent to the customs post at the other border station, involving a two-day processing period.

(5) MICROECONOMIC REFORM

Along with macroeconomic stabilization and a more open policy towards trade and investment, enterprise reform is central to the transition from a planned to a market economy. But it is also generally the most difficult politically (Pomfret, 2002). There is ambivalence towards the private sector, the SOE sector remains substantial and its funding opaque, and as noted the very open FDI regime creates a bias in favour of foreign over domestic firms. In this sub-section, we examine two aspects of the Lao reforms, the regulatory regime and reform of the state-dominated banking sector, against the backdrop of general enterprise dynamics.

At a general level, formal institutions and governance structures in Laos remain weak. The most comprehensive indicators are from the comparative World Bank (2008) governance surveys. Relative to its per capita income, Laos is regarded as politically stable, reflecting the fact that, as also in China and Vietnam, the economic reforms have not been accompanied by political liberalization. This results in it having a very low ranking for voice and accountability. The country's regulatory quality also ranks by far the lowest in Southeast Asia. There are similarly low scores, marginally above bottom-ranked Cambodia, for government effectiveness, rule of law, and control of corruption.

(5.1) The regulatory regime

The Lao commercial climate has been the subject of four detailed firm-level surveys, by the Asian Development Bank and World Bank (ADB-WB, 2005, unpublished), the GTZ 2005 and 2007 enterprise surveys, and the ADB 2009 red tape survey. As in most transition economies, the business regulatory environment is found to be informal, discretionary, potentially complex, corruption-prone and increasingly decentralized. Within the bureaucracy, attitudes towards the private sector and foreign ownership vary substantially.

The ADB–WB Investment Climate Survey of 303 establishments in six sectors and seven provinces reported several major problems (Figure 8). These include infrastructure, regulation, taxation, macroeconomic stability, and access to finance. As expected, the ranking of these factors differed across major sectors. Manufacturing firms ranked infrastructure, regulations, and taxation as the top three constraints, while operators in tourism ranked infrastructure, inadequate skills, and taxation as the major business constraints. More than 30% of firms complained about regulatory policy uncertainty, particularly the uneven interpretation of laws and regulations. According to the survey, firms spent about 5% of their time dealing with officials on regulatory matters. The GTZ Enterprise Survey of 2007, which follows the same format as the previous study, provides additional information on business constraints. It found that business experienced increased problems concerning access to capital, recruiting skilled labour, access to technology and business services, and licensing (Figure 9).

(Figures 8 and 9 about here)

The number of official steps to set up a business in Laos is not much more than the Asia-Pacific average, but the time it takes to navigate them is a major constraint. According to the IFC Doing Business Report for 2006, it takes nine steps to launch a business (a hypothetical warehouse) in Laos. This is similar to the regional average of eight steps, but the duration is more than three times longer (163 days compared to the regional average of 51 days). Inspections by government officials also appear to be excessive. The most frequent are by the forest, customs, and tax departments, in addition to the 'economic police'.[23]

The ADB 2009 Survey supplemented these findings with monetary estimates of the costs of compliance. The study found that firms on average incurred Kips 4.1 million ($483) annually to comply with the three most common licences, namely for enterprise registration, sector operation, and tax. The cost to the business community in aggregate was estimated to be Kip 266 billion ($36 million) annually, or 0.7% of GDP. Including the many other more minor regulations, the total compliance cost was estimated to be in the range 1.5% to 3% of GDP. It was also found that these costs are borne disproportionately by smaller firms. On a per employee basis, business compliance costs were estimated to be $31, $14 and $3 for small, medium and large firms respectively.

The government has attempted to simplify the licensing system. In 2006 a new Law on Enterprises replaced the Business Law of 1994. The Law is an improvement in a number of respects. It includes a 'negative list' of activities that are closed to enterprises. All other activities are automatically open for business, and enterprise applications may proceed directly to the newly established enterprise registration office. Foreign and domestic firms also receive equal treatment, and for the first time foreign investment is formally welcomed. In addition, the government has also set itself a '10-day challenge' as the time period that firms will need to obtain a licence, and firms need only register once, and not every year. To achieve this, the registration system has been simplified, with the number of documents required reduced from 16-18 to 4-6, depending on the sector. A new e-registration system has also been established for firms, with positive results. About 15% of the firms registered under the new system were first-time registrants, suggesting that administrative simplicity has brought firms in from the underground economy, while the 2009 ADB Survey estimated that compliance costs had been reduced by about 35%. However, deficiencies remain. First, the tax incentives regime remains very generous and non-transparent, while incentives are often provided on a firm-specific basis. Second, it remains unclear whether the investment negative list will be synchronized with the enterprise registration negative list.

[23] According to the survey, Laos ranked 159 out of 175 countries in terms of ease of doing business. It ranks a good deal better in terms of starting a business (#73), employing workers (#71) and paying taxes (#36). However, it is ranked among the lowest in the world in terms of getting credit (#173), protecting investors (#170), and trading across borders (#161). It also ranks very low in dealing with licences, registering property, enforcing contracts, and closing a business.

(5.2) Finance sector reform

The financial sector is invariably the Achilles' heal of reform in command economies. The banking sector is central to the survival of the broader SOE sector, as well as being an institutionalized mechanism for dispensing patronage. It may undermine efforts to achieve macroeconomic stabilization. And the sector is politically contentious, as 'reform skeptics' see state-owned banks (SOBs) as one of the last bastions of state control in the face of a more open trade regime and a flourishing private sector.

The Lao financial sector is very shallow (Figure 10). Broad money relative to GDP is about one-fifth that of the more advanced economies of Southeast Asia, and less than one-third that of even Vietnam. Financial deepening is progressing slowly. Banking assets as a percentage of GDP are among the lowest in the Asia-Pacific region. Average interest rate spreads (of loans over deposits) are more than double efficient developing country benchmarks. Historically, the three state-owned banks,[24] which account for more than 60% of total bank assets, have suffered from extremely high non-performing loans (NPLs), in the region of 50-70% in 2003, that is on the brink of insolvency. Several factors explain this outcome: poor credit risk assessments by the banks; directed lending; and persistently late payments to suppliers by the national government, which in turn were passed through to the SOBs.

(Figure 10 about here)

This has been one of the most difficult areas for the reformers. The National Assembly passed a new Banking Law in 2006 that aims to provide equal treatment for state and private banks. New foreign and domestic private entrants appeared from 2007. The bad debts of the two largest SOBs through to 2003 were written off and in effect transferred to the government's balance sheet. In return, more stringent financial performance targets and procedures were implemented. Stronger economic growth and tighter fiscal policy improved the general financial climate. International agencies are providing various technical support programs. Enterprises with international operations are effectively able to access the Thai banking system.

Nevertheless, problems remain. Command lending, or the so-called 'policy loans', continue. SOB capital asset ratios have remained negative for most of the reform period. Loan to deposit ratios are low, around 50%, as are bank penetration ratios, because households prefer to hold cash rather than bank deposits. Moreover, most enterprises do not have access to bank lending – domestic credit to the private sector as a percentage of GDP is about one-quarter the Southeast Asian average. Small-medium enterprises have little access, owing to the cumbersome loan approval processes and the necessity for collateral.[25] Trade facilitation is still relatively costly.

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[24] These are Banque Commercial Exterior Lao (BCEL), Lao Development Bank (LDB), and Agriculture Promotion Bank (APB).

[25] The most frequently used collateral by SMEs in developing countries is land, but land ownership in Laos remains ill-defined and uncertain, and banks typically eschew it as a form of collateral.

(5.3) Enterprise structure and dynamics

A fuller picture of the reform impacts requires micro level data on enterprise dynamics and productivity. Unfortunately, Laos has never had a regular economic census, and so not much data are available. The most complete picture of firms is that provided by GTZ in 2005 and 2007, which surveyed 390-460 enterprises in three districts – central, adjacent and rural – in each of four provinces (Vientiane Capital, Luang Prabang, Luang Namtha and Champasack). The enterprises were mostly micro (1-2 workers) and small operations.

There is evidence of considerable enterprise dynamism. About 19% of the enterprises surveyed had been in operation for less than three years, while only 35% had been in operation for more than a decade. The larger enterprises had been in existence for a longer period (14.1 years compared to 7.4 years for the micro enterprises), again consistent with international experience. Most enterprises surveyed were expanding: 41% of micro enterprises had progressed to larger size groups over the previous two years (Table 3). The survey found that, of the original 135 micro-enterprises, 78 (or 57%) stayed micro, another 55 (or 41%) progressed to the 'small' category and two became medium-sized establishments by 2005. Of the original 198 small firms, 168 (or 81%) remained small, five declined to micro-scale, 31 graduated into medium-sized and one became large. As a consequence of these growth dynamics, the share of medium-sized and large firms in the sample increased from 14.5% to 21.5%. It is not possible to decompose the dynamics by ownership, but most of the growth appears to be among the domestic private firms

(Table 3 about here)

It is similarly not possible to accurately measure firm level productivity over time. To gain an approximate picture, the authors visited a small sample of garment factories, and compared the results with similar firm level surveys in neighbouring economies, where the product (men's long sleeved shirts), technology, and labour management practices are standardized and therefore directly comparable. Labour productivity (measured as output per worker per day) in the Lao garment sector is lower than the average, but unit labor costs are similar to regional comparators (Figure 11). For example, garment factories producing men's shirts in Vientiane reported labour productivity rates ranging between 8 and 12 shirts per worker per day, compared to about 16 shirts in Thailand. But productivity is catching up. One new Japanese-owned garment factory located just outside Vientiane has increased its productivity from five to eight shirts per day within two years, and is on target to reach 12 shirts within another year as workers rapidly acquire on-the-job experience.[26]

[26] The comparative data in Figure 11 also illustrate the scope for further reductions in trade facilitation costs, which for Lao firms amount to about 4% of the (fob) value of exports, double the share of the more efficient Thai and Bangladeshi exporters.

(Figure 11 about here)

(6) CONCLUSION AND SOME LESSONS

The principal conclusion we draw from this case study of Laos is that very poor, latecomer, transition economies can achieve good development outcomes providing a few key economic reforms are enacted, and investors are convinced that reforms are durable and credible. We draw these conclusions from the experience of a country with arguably among the developing world's most unfavourable 'initial conditions': very low income, a history of deep and protracted conflict, two decades of commercial and political isolation, the largest amount of unexploded ordnance per capita in the world, an educated and entrepreneurial class that was almost wiped out in the 1970s, very high levels of indebtedness and aid dependence, very weak formal institutions, and a land-locked location.

The Lao evidence suggests that the handicaps these countries face in re-engaging with the international economy, while daunting, may have been overstated in the literature. The international economy offers a diverse array of niches, that even a very small, disadvantaged economy may penetrate. Policy makers and donors cannot 'pick winners', by sector, let alone enterprise. The main challenge is to provide an enabling environment and to continue the reform from the first round of trade openness and macroeconomic stabilization to the politically more sensitive areas of microeconomic reform, as well as developing supply-side capabilities in infrastructure, education and health. We also show that being land-locked is not necessarily a serious obstacle, providing reform proceeds and there is at least a moderately cooperative neighbourhood.

To understand the growth process, it is also necessary to examine the sources of growth dynamism in Laos and how they link to the reform process. First, garment exports grew from negligible levels to over $100 million per annum in less than a decade once foreign investors were allowed in and trade procedures were simplified. Special market access concessions available for low-income exporters of course facilitated this outcome, but it would not have occurred without the reforms. Second, tourism revenue has also grown rapidly, in spite of the country's isolation (and a national airline that has very limited international reach), once the country was opened up and basic infrastructure was provided. Third, opening up to the global economy and providing a more secure investment environment have also created opportunities to exploit natural resource advantages, which in turn has transformed the government's capacity to reduce its high debt levels and to provide much needed public goods. We have shown that Laos has effectively tapped into two such natural resource opportunities, in mining and hydropower generation. Fourth, access to international labour markets, particularly that of neighbouring Thailand, provides significant remittances, as does a more welcoming attitude towards the country's sizable diaspora. Moreover, success creates its own constituency for further reform, even in authoritarian states such as Laos. Quite modest achievements embolden reformers to pursue a second round of more difficult, microeconomic reforms.

Being small, as the majority of least developed economies are, also has its advantages. International market access is unlikely to be a problem, as these economies pose no commercial threat. Many very small economies do not attempt to run an independent monetary policy. Although this deprives the government of an important policy lever, and possibly some loss of revenue, it also reduces the scope for major policy errors. Similarly, once embarking on the transition from plan to market, these economies have little choice but to opt for open economic policies, especially where they are landlocked and surrounded by largely open economies.

Inevitably the transition from plan to market involves a complex interplay of economics and politics, with fully reformed sectors and policies co-existing uneasily with the partially reformed. In this interim period, the policy regime may appear messy in some formal sense, but it may be de facto effectively operational. A good example of this in the Lao case is monetary and exchange rate policy, which as we have seen is ‘unorthodox’ but in practice has delivered quite good macroeconomic outcomes for over a decade, and has provided the reformers with the policy space to tackle other reforms. Property rights are another example, which are de jure unsettled but which mostly operate satisfactorily de facto.

Two factors have obviously worked to Laos’s advantage, but in neither case should the impact be overstated. The first is its proximity to larger, fast-growing economies. These provide both a locomotive effect, through trade, investment and employment opportunities, and a demonstration effect of successful reforms. In the latter case, Vietnam has been particularly important, since the Lao government has essentially imitated both its economic and political approach to reform. Conversely, these beneficial effects are conditional. Lao relations have been occasionally uneasy with two of its neighbours, Burma and Thailand. Moreover, beneficial neighbourhood effects only work if countries seize the opportunities by reforming at home. Burma has stagnated in the same region for five decades.

Second, as shown above, Laos has been a large recipient of international aid flows, generally on concessional terms. While the net effects have undoubtedly been positive, here also, as the international literature shows (see for example Chauvet and Collier, 2008), the benefits are conditional upon successful reforms. Moreover, these benefits should not be overstated. Like all very small countries with weak bureaucracies, Laos struggles to meet the myriad demands and modalities of more than two dozen competing donors. As a generalization, donors have been more effective in the provision of technical assistance, training and infrastructure, but much less so as drivers of a clearly articulated reform agenda.[27] For the latter, reforming neighbours, particularly Vietnam and earlier the more advanced economies of Southeast Asia, have been the most important source of both ideas and practical development strategies.

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[27] Interestingly, the IMF no longer has a presence in the country, in spite of the unfinished macroeconomic policy agenda.

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Table 1: Lao Social Indicators, 1990-2005

Indicator	1990	1995	2005
Infant mortality rate (/1,000)	120	104	70
Life expectancy at birth (years)	50	51	61
Adult literacy (%)	57	60	73
Primary school enrolment (%)	63	69	84
Poverty headcount index (%)			
Consumption PPP	72.3	na	48.8
Poverty survey PPP	76.6	na	53.6
Gini ratio (expenditure)	0.29	0.36	0.33

Notes and sources: Extracted from ADB (2006), ADB (2008), and UNDP (2006). Poverty and inequality data refer to years 1992/93, 1997/98 and 2002/03. See sources and text for additional explanation.

Table 2: Effective Rates of Protection, 2005 (%)

Sector	**Export or Import Sector**	**ERP**
1. Crops	E	-5.0
2. Livestock and poultry	E	-8.0
3. Forestry and logging	E	-11.8
4. Mining and quarrying	E	-11.0
5. Food, beverages and tobacco	I	104.8
6. Textiles, garments and leather products	E	-6.8
7. Wood and paper products, printing and publication	E	-0.4
8. Chemical products	I	2.0
9. Non-metallic mineral products	I	-4.3
10. Metal products, machinery	I	9.5
11. Other manufactured products	I	6.1

Source: Authors' estimates.
Notes: E = export-oriented sectors; I = import-oriented sectors.

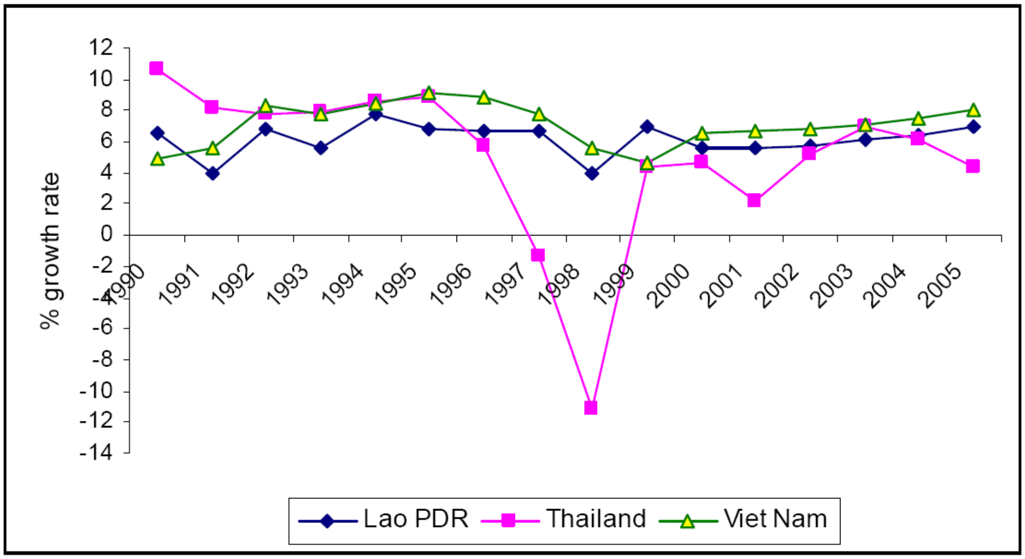
Table 3: Enterprise Dynamics

Size Before Survey in 2005

Firm size	Micro	Small	Medium	Large	Total in 2005 survey
Total prior to 2005	135	198	43	14	390
Large	0	1	11	8	20
Medium	2	31	28	5	64
Small	55	161	6	1	223
Micro	78	5	0	0	83

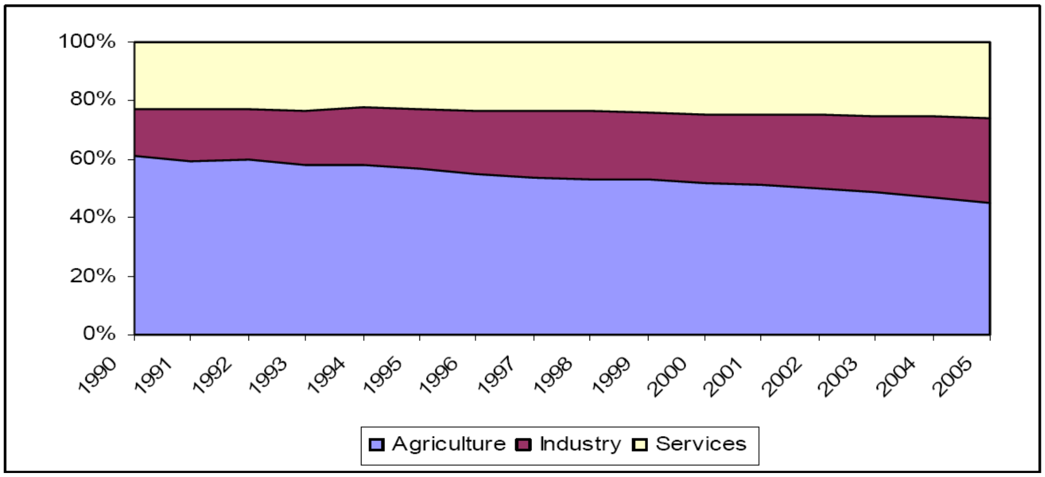
Firms measured by employment
Source: GTZ (2006).

Figure 1: Economic growth, 1990-2006, Laos and Neighbours (%)



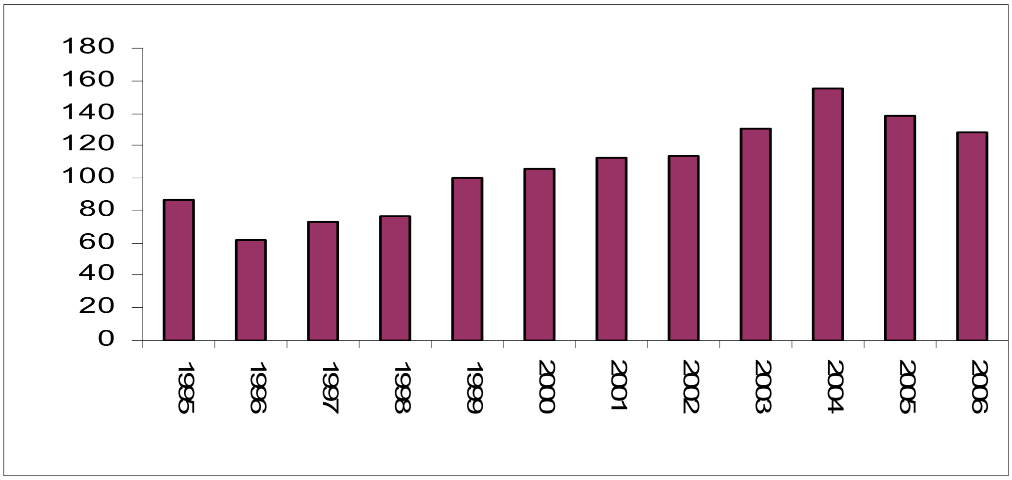
Source: National accounts data from each country.

Figure 2: The Structure of the Lao Economy, 1990-2007 (% of nominal GDP)



Source: Estimates from National Income Accounts, National Statistics Center, Vientiane Lao PDR

Figure 3: Garment exports, 1995-2006
($ millions)



Source: Trade Data, National Statistics Center, Vientiane Lao PDR

Figure 4: Tourism, 1990-2007
(visitors in 000's, LHS; revenue in $million on RHS)

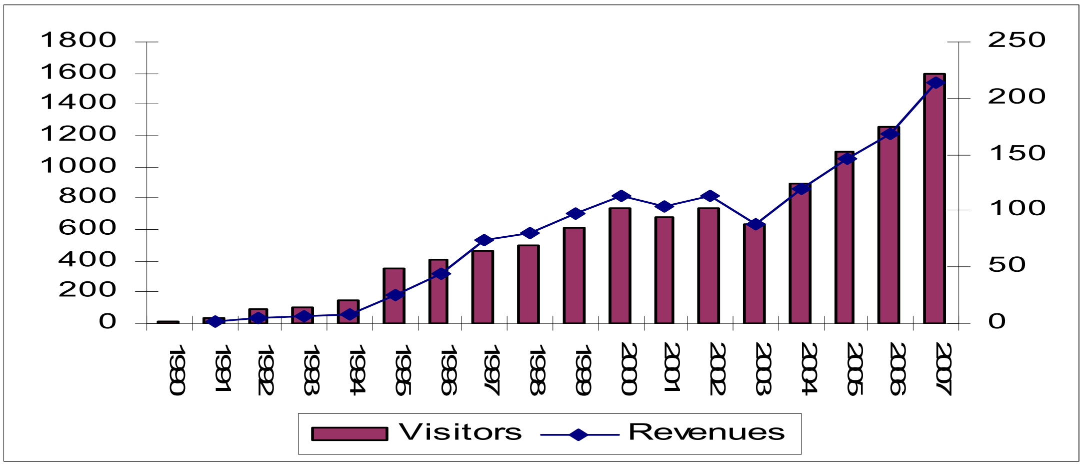
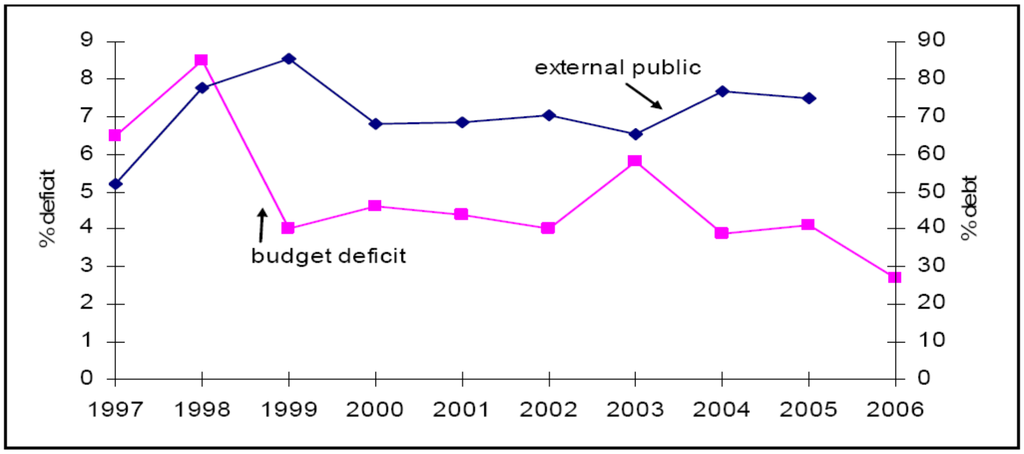
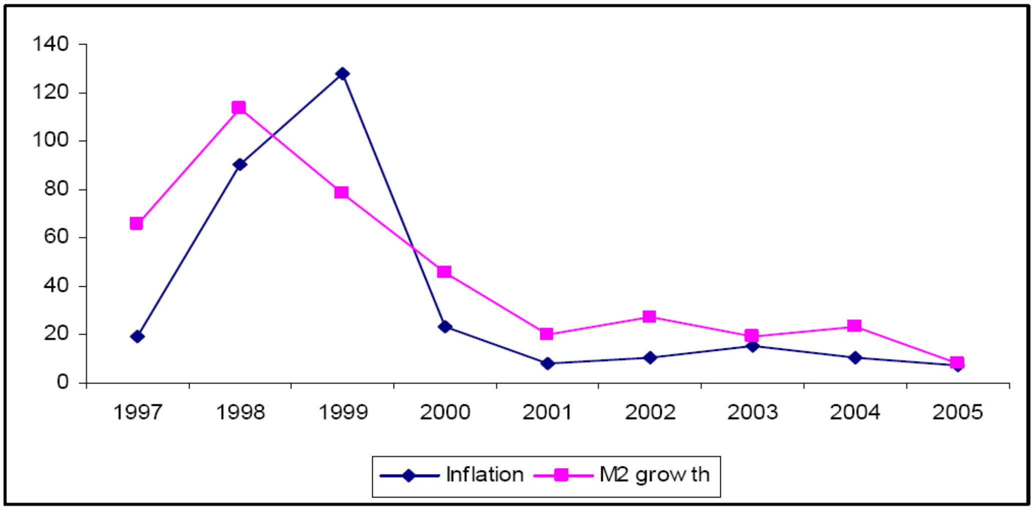


Figure 5: Fiscal Deficit and Public Debt, 1997-2006 (% of GDP)



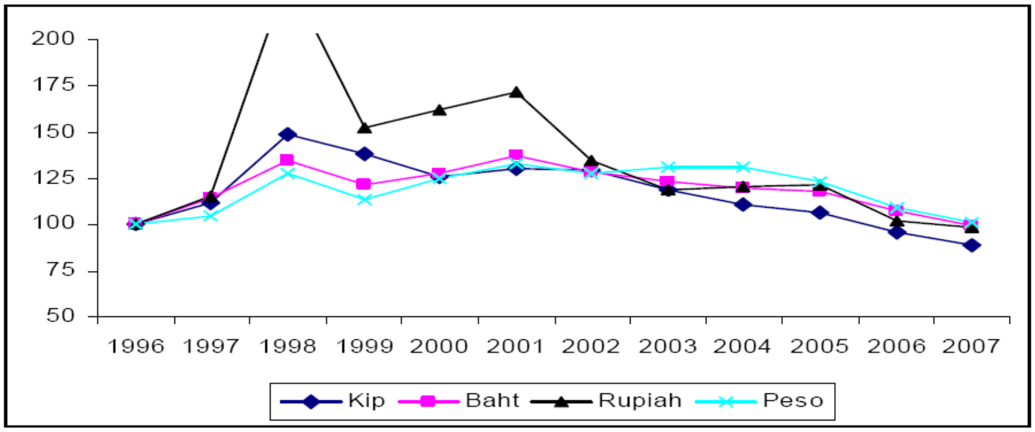
Sources: Ministry of Finance and Bank of Lao PDR, and IMF (2006).

Figure 6: Inflation and Money Supply, 1997-2005 (%)



Source: Consumer price index from National Statistics Centre, broad money supply from Bank of Lao PDR.
Note: Broad money (or M2) comprises cash in circulation, and demand and time deposits held in banks.

Figure 7: Real Exchange Rates, 1996-2007, Laos and Neighbours (1996 = 100)



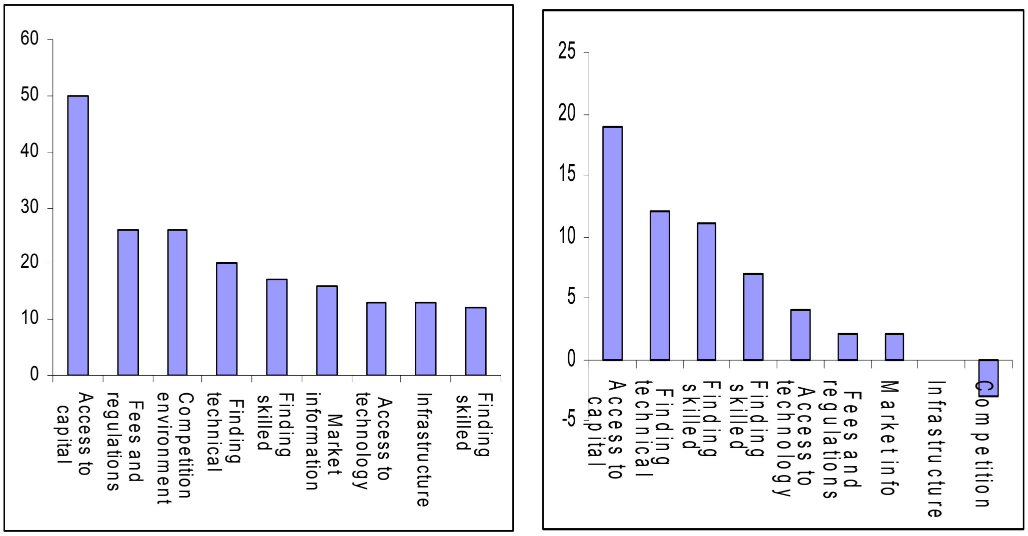
Notes: Real exchange rate for Kip (Baht) estimated as: nominal Kip/$ rate adjusted by differences in changes in the Lao PDR consumer price index and the U.S non-fuel import price index. The Lao consumer price index is a proxy for non-tradable prices, and the import price index is a proxy for international prices of tradable goods. A decline in the index indicates an appreciation in the real exchange rate

Source: Bank of Lao PDR, Bank of Thailand, and US Department of Labor and Statistics.

Figure 8: Establishments Identifying Problems as "Major" or "Very Severe" Obstacle to Growth (% of firms)

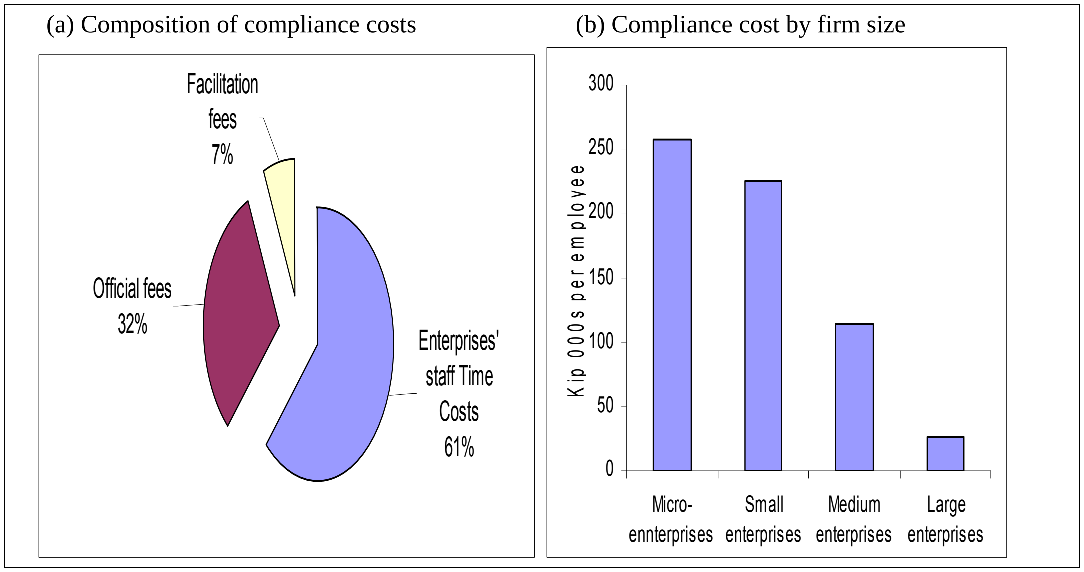
(a) % of enterprises reporting as major constraint

b) Change in % of enterprises reporting factor as major constraint between 2005 and 2007



Source: 2007. GTZ. *Enterprise Survey of 2007*, Vientiane.

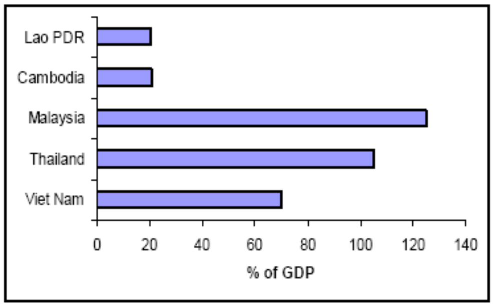
Figure 9: Business Compliance Costs*



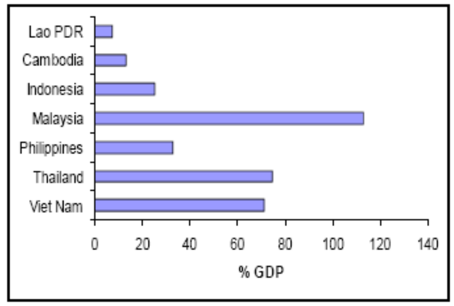
Source: ADB (2009).
Note: * refers to compliance costs per employee of the three main permission – enterprise registration, operational permissions and tax certificate.

Figure 10: Comparative Financial Indicators: Laos and Neighbours

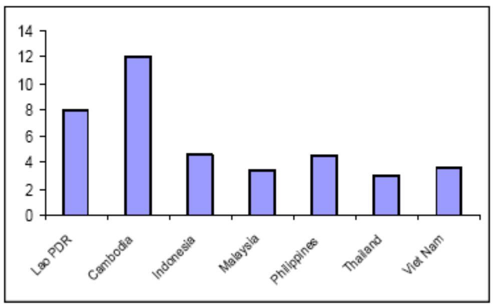
A. Broad Money Supply as a % of GDP



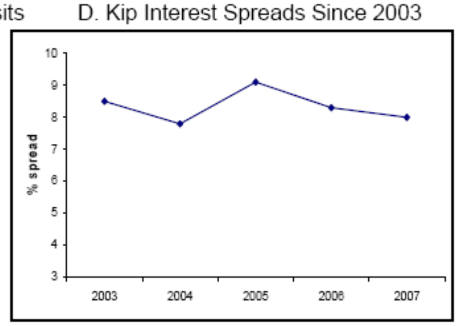
B. Domestic Credit to the Private Sector as % of GDP



C. Average Interest Spreads of Loans Over Deposits



D. Kip Interest Spreads Since 2003

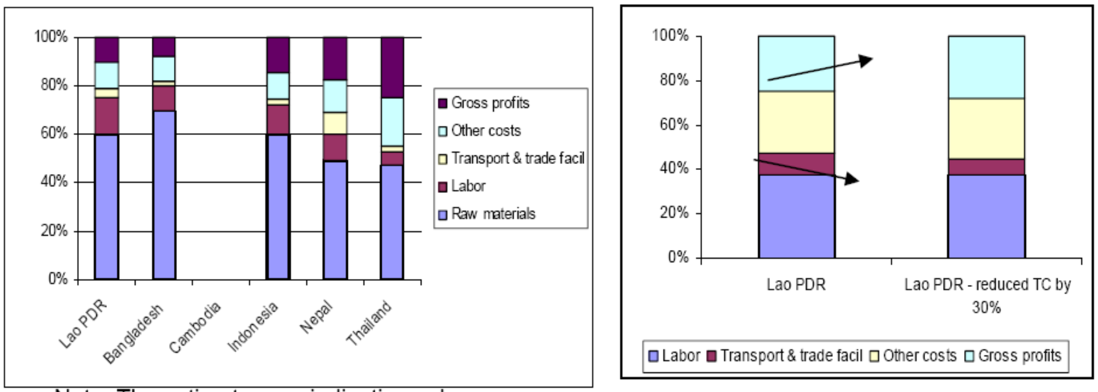


Sources: Central banks, various countries. Average interest spreads refer to local currency lending rates over deposits rates.

Figure 11: Distribution of FOB Prices of Men's Cotton Shirts Produced in Similar Garment Factories

A. Composition of FOB Prices

B. Impact on Profit Margins from a 30% cut in Transaction Costs



Note: The estimates are indicative only
Source: Chart A: fieldwork estimates for Lao PDR, Cambodia, and Indonesia. World Bank estimates for Bangladesh, Nepal and Thailand, from various diagnostic trade studies.

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