Prakash

INTERNATIONAL MONETARY FUND

IMF Country Report No. 12/286

LAO PEOPLE'S DEMOCRATIC REPUBLIC

2012 ARTICLE IV CONSULTATION

October 2012

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with Lao People's Democratic Republic, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 5, 2012, with the officials of Lao on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 16, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its August 31, 2012 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Lao People's Democratic Republic.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

August 16, 2012

KEY ISSUES

Context. Against the backdrop of generally sound policies and abundant natural resources, Lao P.D.R. has made impressive progress in developing its economy and reducing poverty. The key challenge going forward is to ensure that economic policy frameworks stay ahead of the curve to achieve sustainable and broad-based growth.

Outlook and risks. Economic performance remains strong with growth projected at 8.3 percent in 2012 before slowing modestly in the medium term. Spillovers from the global environment are expected to be modest, allowing policies to focus on reducing home-grown risks from rapid credit growth and inadequate reserve coverage.

Monetary policy was appropriately tightened in 2011 but has been passive since, inflation has been contained, and the exchange rate has been stable despite liberalization of foreign exchange transactions. Further tightening remains necessary to reduce credit growth and replenish reserves.

Financial sector indicators reportedly remain sound, but this masks underlying vulnerabilities from rapid credit growth. Financial sector supervision should be strengthened and prudential measures deployed to maintain banking sector soundness.

Fiscal policy has been broadly appropriate, but rapid civil service wage growth could crowd out higher priority spending. The debt distress rating has improved to moderate risk.

Building broad-based and inclusive growth. Structural reforms to improve the business climate and trade integration are progressing as the authorities aim to complete entry conditions for WTO accession by year-end.

Approved By
D. Cowen and M. Miyazaki

Mission team: D. Botman (Head), N. Duma, T. Feridhanusetyawan N. Ha, T. Severo (all APD), and S. Kalra (Resident Representative).
Mission Dates: June 26–July 5, 2012

CONTENTS

INTRODUCTION

1. **Lao P.D.R. has made impressive progress in developing its economy and reducing poverty.** Growth averaged 7 percent per annum over the last decade—among the highest in the region, with poverty incidence declining markedly. The country has also made significant progress towards achieving the Millennium Development Goals (MDGs). Macroeconomic policies have remained generally sound, with inflation within the official target, the fiscal deficit near pre-global financial crisis levels, and the exchange rate stable, but low reserve coverage and rapid credit growth amid high lending rates could be a source of vulnerability. The authorities' development plan, which became operational in October 2011, targets growth of at least 8 percent annually and achieving the MDGs by 2015[1].

2. **In concluding the 2011 Article IV consultation, Executive Directors** agreed with staff that further fiscal and monetary tightening would be important to curb inflation and support the external position. They also agreed that the frameworks for macroeconomic and financial policies should be strengthened and that structural reforms be accelerated to diversify the economy, improve the business climate, and foster trade. The authorities have tightened policies further and taken steps to safeguard financial sector soundness, including the recapitalization of the major state-owned commercial banks (SOCBs). Structural reforms have been accelerated in the context of commitments under the ASEAN Economic Community and the prospect of World Trade Organization (WTO) accession, which have been catalysts for economic reform and transparency.

3. **Against this backdrop, the discussions focused on policies to maintain macroeconomic and financial stability while building the foundations for more broad-based growth**. There was broad agreement that the outlook for Lao P.D.R. is bright and that the recent improvements in economic performance and institutional capacity warranted a reclassification of the country's debt dynamics to a moderate risk of debt distress. The authorities and staff agreed that downside risks from the global outlook are limited and that therefore policies needed to focus on maintaining financial sector soundness and on growing international reserves over time. In this regard we shared the view that monetary and fiscal policies should remain sufficiently tight. The authorities were more sanguine about financial market developments, but agreed that the quality of credit growth should be carefully monitored and recognized that oversight of the financial sector needed further improvement to stay ahead of the curve. Looking ahead, it will be important for the authorities to enhance competitiveness in the nonresource sector through continued structural reforms and to accelerate Public Financial Management (PFM) reforms, which would allow the budget to make a greater contribution to inclusive growth.

[1] See the Lao P.D.R. Poverty Reduction Strategy Paper (EBD/12/1) and the Joint Staff Advisory Note (EBD/11/92).

ECONOMIC CONTEXT

A. Growth is Strong and Macroeconomic Policies Have Been on the Right Track

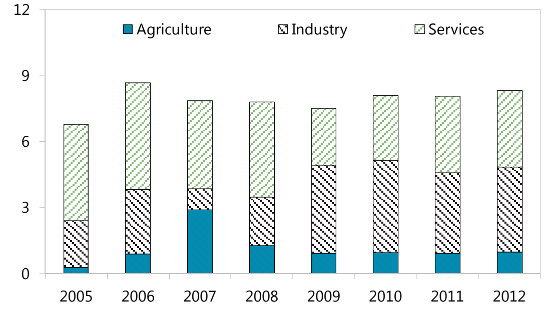
4. Economic activity remained strong in 2011. Despite monetary and fiscal tightening, global uncertainty, and natural disasters in Lao P.D.R. and main trading partner Thailand, real GDP growth is estimated at 8.0 percent. Activity was buoyed by mining and hydropower investments and construction, while the expansion in the services sector was indicative of resilient domestic demand.

5. Inflation pressures have moderated, with the headline rate falling to 3.6 percent (y/y) in June 2012 from a peak of 9.8 percent (y/y) in mid-2011, reflecting moderating food and fuel price increases, policy tightening, and base effects.

6. The fiscal deficit has declined sharply and is now at the pre-global financial crisis average. The overall fiscal deficit moderated to 3.0 percent of GDP in FY2011 (October 2010-September 2011) from 4.6 percent of GDP in FY2010, due to expenditure restraint and buoyant mining and hydropower revenues, while VAT revenue exceeded the conservative budget target following the expansion in registered taxpayers. Debt service costs remain manageable given the concessional nature of official borrowing.

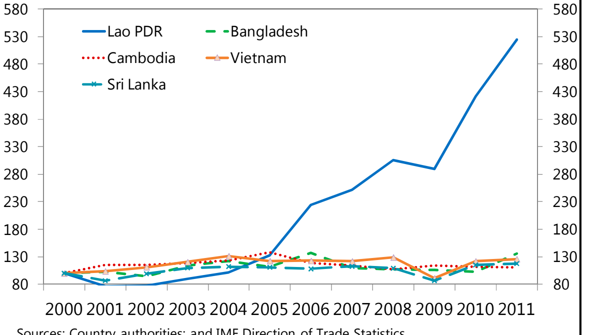
7. Despite fiscal tightening, monetary conditions remain accommodative. The Bank of the Lao P.D.R.'s (BoL) quasi-fiscal operations of providing loans to local governments continues, but its monetary impact was mitigated in 2011 by accelerating the sale of

Contribution to GDP growth
(In percent)



Sources: Country authorities; and IMF staff estimates

Export Performance, 2000–2011
(2000=100)



Sources: Country authorities; and IMF Direction of Trade Statistics.

BoL securities in line with past staff recommendations. As a result, the growth of broad money declined substantially to 25 percent (y/y) at year end. However, growth in monetary aggregates picked up again, with the BoL continuing its quasi-fiscal lending operations while tempering its security sales. Quasi-fiscal lending and private sector credit expansion contributed to a rise in credit to the economy to close to 44½ percent (y/y) in April—the highest rate of growth since October 2010.

8. Strong domestic demand, fueled by credit growth, and resource sector activities

continue to create pressures on the balance of payments. Nonresource import growth outpaced export growth, with the overall current account deficit widening to US$1.7 billion in 2011 (21.4 percent of GDP), while gross international reserves declined by US$50 million to US$677 million at year-end, covering about two months of prospective nonresource imports, the lowest level in almost a decade. Foreign direct investment (FDI) increased sharply, mainly for hydropower projects, and covered about 70 percent of the headline current account deficit in 2011.

B. The Outlook is Favorable, but Domestic Risks are Elevated

Staff Views

9. Near-term prospects are generally favorable.

- ***Growth*** is projected to accelerate in 2012 to 8.3 percent in light of the pause in policy tightening, a recovery in agricultural production, and public construction activities related to the Asia-Europe Meetings (ASEM). Over the medium term, growth is expected to slow only moderately.[2]

- ***Inflation*** is projected to average 5.1 percent in 2012, before increasing in 2013 to 6.8 percent reflecting base effects and public wage bill pressures, which could also fuel higher private sector wage demands. Against the backdrop of still accommodative financial policies, inflation is subject to considerable uncertainty, as potential shocks to food and fuel prices could quickly translate into higher inflation.

- ***The fiscal deficit*** is projected at 2.5 percent of GDP in FY2012 and FY2013, as higher revenue collections and savings from the reduction in off-budget capital spending are largely used for a significant increase in the civil service wage bill.

- ***Growth in credit*** to the economy is expected to slow through end-2013 given lower financing of local governments and with loan-to-deposit ratios already near regulatory thresholds.

- ***On the external side***, the nonresource current account deficit is expected to widen in 2012 to 19.1 percent of GDP, while the level of international reserves is projected to rise to US$723 million by year-end due to a significant pickup in FDI inflows and nonresource exports, but with the cover remaining around two months of imports.

10. The outlook is subject to a number of, mostly home-grown, downside risks. The strong momentum in foreign-funded investment and the nonresource sector could increase growth relative to the staff's forecast. On balance, however, the outlook is subject to renewed global financial turbulence as well as three, arguably more important, internal vulnerabilities:

- ***Spillovers.*** The global growth outlook is still sluggish and subject to significant downside risks. For Lao P.D.R., judging from the growth experience during 2009, spillovers

[2] The moratorium on mining and land (for rubber plantations) concessions that will last through 2015, applies to new proposals only and does not affect mining and hydropower investment proposals that were submitted prior to the moratorium.

appear small, although unprecedented policy stimulus at the time, for which there is less space now, likely contained the fallout. There are a number of reasons to expect modest spillovers will prevail, given the country's limited integration with global markets, continued supportive growth in main trading partners Thailand and China, and with most hydropower contracts contracted for the long term. The main channel of contagion from slower global growth would be through lower gold and copper export prices, while in the event of an extreme stress such as a domestic financial crisis, Lao P.D.R. would likely experience acceleration in dollarization, loss of reserves, and significant balance of payments pressures.

- ***Financial sector risks***. The rapid expansion of the financial sector in recent years raises concerns about banking sector soundness and a possible emergence of contingent fiscal liabilities down the road. Despite some slowdown in 2011, credit growth is on the rise again in 2012 putting recent stability gains at risk. Global shocks could expose these domestic vulnerabilities.

- ***External risks.*** Reserve levels offer inadequate protection against external and internal risks (Box 1). The core balance of payments—defined as the current account balance net of FDI and ODA—remains in deficit at around 4 percent of GDP, leaving the external position vulnerable to terms of trade shocks, potentially volatile capital inflows, and possible concerns about banking sector soundness or shocks to inflation.

- ***Fiscal risks.*** The level of public sector debt remains elevated compared to other LICs in Asia. While off-budget capital spending has declined, it remains indicative of weak spending controls that could give rise to additional contingent liabilities.

Authorities' Views

11. The authorities broadly shared the staff's outlook and assessment of risks. They noted the key challenge was to ensure that growth remains inclusive and broad-based, consistent with their development plan. In this context, the authorities recognized top priorities were scaling up education and health care spending and diversifying the sources of growth. They agreed that the impact of spillovers were likely to be modest and that instead policies should be focused on monitoring and improving the quality of banking sector credit and replenishing the level of international reserves over time.

MAINTAINING MACROECONOMIC STABILITY

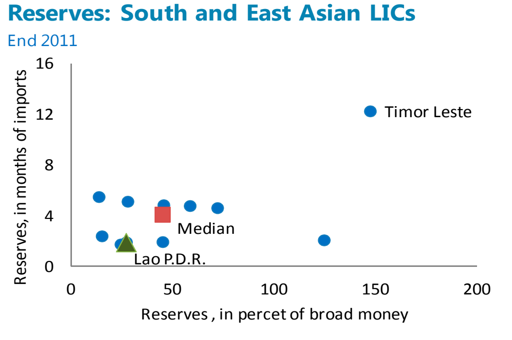
12. Policies will need to be sufficiently tight to avoid jeopardizing recent financial stability gains. Monetary policy and strong banking supervision are likely to be the "first line of defense" against excessive credit growth, but tighter fiscal policies will also contribute and reduce the current account deficit.

Box 1. Reserve Adequacy and Risks to External Stability

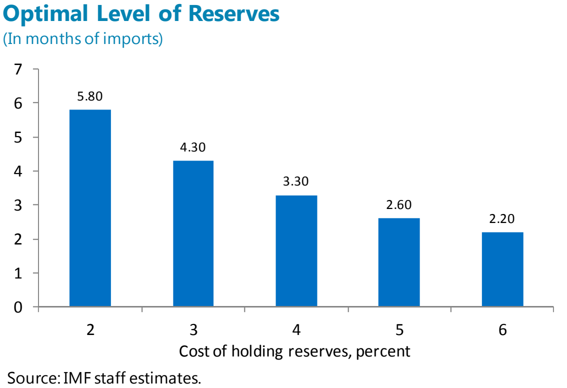
Traditional metrics indicate that, at current levels, Lao P.D.R.'s international reserves do not offer adequate protection against external shocks. Common rules of thumb suggest that reserves should cover at least three months of prospective imports or be equivalent to up to 50 percent of broad money. Lao P.D.R. falls short on both counts and has low reserves coverage compared to other low-income countries (LICs) in Asia.

Lao P.D.R.'s optimal level of reserves is estimated to be close to three months of imports. This is based on a recently developed methodology and assumes the opportunity cost of holding reserves is around 4 percent.[1] In applying the model to Lao P.D.R., shock variables (terms of trade, external demand, FDI to GDP ratio, and aid to GDP ratio) were set at the lower 20 percentile of the country-specific distribution over the past ten years (2001–2010). Fundamental indicators (CPIA and fiscal balance) were set at their most recent levels. These choices capture the volatility of shocks to the economies of Lao P.D.R.'s main trading partners and to its terms of trade, which constitute important sources of risk to the external balance.

In the near term, the estimated optimal import coverage ratio should be seen as a lower bound on the adequate level of international reserves. The framework assumes risk neutrality. Moreover, the methodology does not account for the high degree of dollarization in Lao P.D.R's economy. Previous research advocates higher foreign reserves coverage for dollarized economies, as currency substitution is easier under moderate dollarization. Higher coverage would also mitigate the risk a run on dollar deposits out of fear for expropriation, in the event of a balance of payments crisis.[2] In this regard, it is also advisable that the assets of the deposit insurance fund mirror the currency composition of deposit liabilities in the banking system.



Source: IMF staff estimates



Source: IMF staff estimates.

[1] See the IMF Working Paper *Optimal Precautionary Reserves for Low-Income Countries: A Cost-Benefit Analysis* (WP/11/249) and IMF Board Paper *Assessing Reserve Adequacy* (February 14, 2011). The opportunity cost of holding reserves is measured as the difference between the cost of external debt and the return on reserves. For Lao P.D.R., the average cost of concessional and nonconcessional borrowing is used to proxy the cost of external debt. The definition of broad money includes foreign currency deposits and the de jure exchange rate classification as flexible is followed.

[2] See the IMF Working Paper *The Optimal Level of Foreign Reserves in Financially Dollarized Economies: The Case of Uruguay* (WP/07/265) and references therein.

A. Monetary Policy: Supporting Sustainable Development by Slowing Credit Growth

Staff Views

13. Although inflation is manageable, in the context of heightened financial and external risks, further tightening is needed. Staff urged the BoL to contain the expansion in Net Domestic Assets by accelerating the exit from quasi-fiscal lending to local governments. In the meantime, BoL securities should be issued to sterilize these lending operations. An increase in the required reserve ratios would reduce excess liquidity, while an increase in policy rates would unlikely affect lending conditions due to the weak transmission mechanism. Tighter monetary policies could also reduce the moderate overvaluation of the kip (Box 2) and contribute to external stability.

14. A stabilized exchange rate remains the appropriate monetary anchor for Lao P.D.R., but there is scope to enhance the policy framework. Given the importance of Thailand as a trading partner, staff supports the authorities' implicit objective of stabilizing the value of the kip vis-à-vis the U.S. dollar and the Thai baht in order to meet inflation objectives and to support efforts to de-dollarize[3]. Nevertheless, to achieve this intermediate target, it will be important to maintain appropriately tight macroeconomic policies. The current practice of expressing the official inflation target in terms of real GDP growth could give rise to pro-cyclical policy moves. Staff recommended instead that the BoL considers adopting an explicit inflation target range over the medium term. To get there, the BoL needs to improve the compilation of monetary statistics to enhance liquidity forecasting and foreign exchange cash-flow projections and to develop the interbank foreign exchange (FX) market, which at present consists of spot FX transactions only, as was noted in the 2011 Article IV consultation. Staff noted the IMF is willing to support these activities through technical assistance and training.

Authorities Views

15. The authorities felt that current policy settings were generally appropriate. Although broadly agreeing with the staff's recommendation to issue additional BoL securities, demand for these instruments was tepid, while the BoL saw raising the reserve requirement as a measure of last resort as this would put an additional burden on banks' liquidity position, especially the smaller ones. The authorities argued that the current policy settings struck the right balance for achieving the multiple BoL objectives. Over the medium-term, once the monetary policy framework was sufficiently strengthened, the BoL indicated it could consider adopting an explicit inflation target range. In this regard, they noted that the country was still dollarized and that this affected both the conduct and transmission of monetary policies. At the moment, foreign currency deposits consisted

[3] Recent gains to entrench macroeconomic stability, including from the increased credibility of monetary policy, has allowed the authorities to partially liberalize foreign exchange transactions, which could further contribute to supporting the usage of the kip.

Box 2. The Conduct of Monetary Policy in Lao P.D.R.

The conduct of monetary policy in Lao P.D.R. is still at a rudimentary stage. Monetary policy relies to a great extent on regulations-based instruments. The interbank market is rudimentary and financial intermediation is in the process of developing.

Monetary policy pursues multiple targets. While the Bank of the Lao P.D.R. (BoL) law states that one of the roles of the central bank is to promote and maintain the stability of the kip, the BoL also pursues several other objectives including targeting growth in net domestic assets, the inflation rate, and five-year plan's GDP growth target. In addition, the BoL has a financial stability mandate. In practice, the BoL interprets the monetary policy objectives as keeping the inflation rate below the real GDP growth rate, keeping M2 growth below 25 percent, and limiting exchange rate volatility vis-à-vis the U.S. dollar and the Thai baht within +/- 5 percent band each year.

The BoL lacks full operational independence to set a more narrow monetary policy objective. Article 2, 2.2 of the BoL Decree on the Organization and Activities instructs the BoL "to study the national monetary policy-plan and submit it to the government for consideration and to implement this policy-plan effectively after approval by the National Assembly."

In recent years, the BoL has used several instruments to implement monetary policy:

- *Reserve requirements*: The reserve requirement has been set at 5 percent for kip deposits and 10 percent for foreign currency deposits since May 2006. In 2008, a reserve requirement for eligible certificates of deposit was introduced at 2 percent for both kip and foreign currency. Neither the required nor excess reserves are remunerated.
- *Standing facilities*: The BoL has a noncollateralized overdraft lending facility, on which banks can draw for short-term liquidity. Overdrafts must be paid within seven days. Interest is charged at a fixed rate set by the BoL and adjusted infrequently. This rate is generally regarded as the policy rate, as it is the only central bank rate that is published.
- *Money market operations* (OMO): the BoL utilizes net sales of BoL bonds (a short-term instrument) and auctions of treasury bills to conduct OMO. Net sales of BoL bonds have been the most active instrument in recent years, as they have been used to sterilize BoL's quasi-fiscal operations. Treasury bills have been used much less.
- *Statutory liquidity requirements* (SLR). Banks are required to hold a liquidity ratio of 20 to 25 percent.

The presence of dollarization constrains the BOL's ability to serve effectively as a lender of last resort. While the extent of dollarization has declined over the past decade, it remains high. Going forward, it will be important to continue to maintain macroeconomic stability; promote financial intermediation in the kip in tandem with stronger bank supervision and accumulate international reserves to withstand any exchange rate pressure; and, over-time, build market-based monetary policy tools and the interbank market.

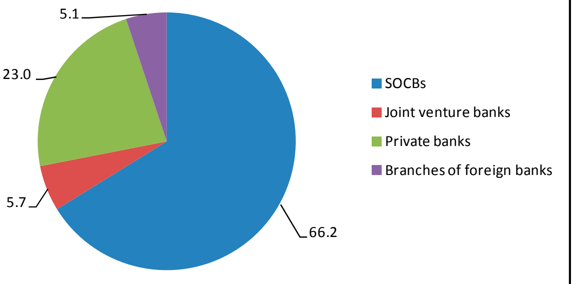
mainly of dollars and baht, but in the future other currencies might be added, further complicating the conduct of monetary operations.

B. Financial Sector: Strengthening Supervision to Support Soundness

Staff Views

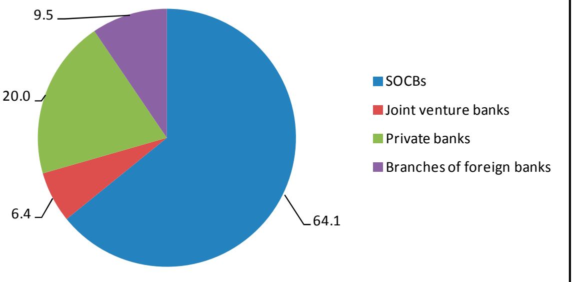
16. Rapid credit growth raises concerns about the health of the banking system. Stronger credit growth can be indicative of financial deepening, in itself a welcome development, provided that its pace is not excessive and improvements in regulatory and supervisory enforcement capacity stay ahead of the curve. Competition for deposits by an increasing number of banks in combination with high lending rates, calls in doubt whether banks can continue to benefit from high-yield projects while sustaining debt repayment and avoiding balance sheet problems over time. Although NPLs, as reported by the BoL, are low at present, this mainly reflects rapid credit growth and possibly the restructuring of loans before they become past due. Risk management capacities of banks are weak and although the capital adequacy of the three SOCBs has increased following a recapitalization, it remains below the regulatory minimum for two of them. Anecdotal evidence suggests connected lending is prevalent and that credit growth is fueling rapid real estate price increases, which are not fully captured in the CPI inflation.[4]

Deposits of Commercial Banks
(Fourth quarter 2011; share in total)



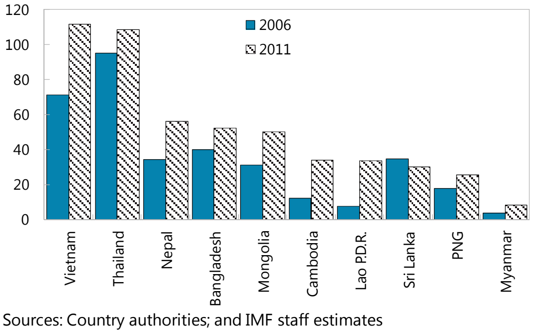
Sources: BoL; and IMF staff estimates.

Loans of Commercial Banks
(Fourth quarter 2011; share in total)



Sources: BoL; and IMF staff estimates.

Credit to the Economy
(In percent of GDP)



Sources: Country authorities; and IMF staff estimates

17. Aside from policy tightening, there is a need to strengthen banking supervision and enforcement and enhance the prudential toolkit. Although onsite and offsite inspections of banks take place regularly, the supervisory approach remains compliance-based and does not adequately address risks. In addition, data gaps and poor

[4] Some of the weaknesses came to the fore in 2011 when one of the private banks experienced a bank run following a false rumor and the BoL had to step in and provided blanket liquidity support.

data quality hamper the ability to adequately monitor the system, while supervisory capacity is spread thinly as the number of banks is expanding rapidly. Staff encouraged the authorities to participate in the IMF-World Bank Financial Sector Assessment Program (FSAP). Careful monitoring of property sector developments and enhancing the prudential toolkit by setting exposure limits to real estate could help prevent potential asset-price bubbles. Staff indicated that SOCB recapitalization plans should be linked to memoranda of understanding that would lay out structural conditions and performance criteria for disbursing capital, while independent audits should continue. Further capital market development, including through additional listings on the stock exchange and development of the local bond market, would help to reduce the reliance on the banking system. There is a need for clear and impartial oversight of both the stock and bond markets.

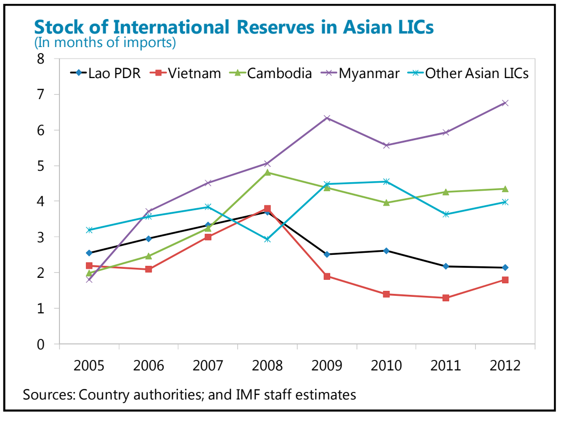
Authorities Views

18. The authorities agreed that maintaining the credit quality is essential for sustainable growth, but were more sanguine about financial sector risks. They saw current credit growth in line with the overall objectives set out in the development plan. Furthermore, it had slowed substantially from the peak of 2009 and reflected welcome financial deepening and strong deposit growth. In their view, financial sector indicators remained sound and overall leverage compared favorably to other low-income countries in the region. The authorities had also strengthened the financial operations of the SOCBs and had taken steps to safeguard financial sector soundness, including increasing the minimum capital requirement and issuing a new regulation on loan classification and provisioning requirements. The authorities said they would consider participation in the FSAP and continue to upgrade their systems in preparation for this. They also would consider requesting input from the IMF on the Anti Money Laundering/Combatting the Financing of Terrorism Law currently being drafted for submission to the National Assembly by year-end. In addition, the authorities are encouraged to address the shortcomings in their anti-money laundering and combating the financing of terrorism (AML/CFT) regime, identified in the 2011 evaluation by the Asia/Pacific Group on Money Laundering (APG).

C. External Stability: Building a Reserve Cushion for Dealing with Adverse Shocks

Staff Views

19. Current reserve coverage is inadequate for dealing with shocks. There is a risk that rapid credit expansion and large capital inflows are funding private sector imports of consumption goods rather than future exports by bolstering productive investment outside the mining and



hydropower sector, implying further erosion of reserve coverage in the future and leaving Lao P.D.R. vulnerable to terms of trade shocks; Staff noted that capital inflows are also potentially volatile, including FDI which for other countries was proven to be less robust during the global financial crisis than previously believed. Finally, concerns about banking sector soundness or shocks to inflation could lead to currency substitution, eroding reserves directly and through additional foreign exchange intervention to keep the kip stable.

20. Maintaining sufficiently tight macroeconomic policies and structural reforms would improve reserve coverage. Reserve coverage is low compared to most other LICs in Asia, with staff encouraging the authorities to take advantage of prospective large capital inflows to build reserves. A CGER-like assessment suggests that, on average, the kip's overvaluation is moderate, but has declined since the last consultation (Box 3). Given the stated objective of limiting nominal exchange rate volatility, a continued reduction in the degree of overvaluation is consistent with further tightening of macroeconomic policies in order to contain inflation at or below trading-partners levels and slow down nonresource import growth. Over the medium-term strengthening the reserve cover requires productivity-enhancing in the nonresource sector.

Authorities Views

21. The authorities felt reserve coverage was broadly adequate, but would try to take advantage of strong capital inflows to increase buffers further. They took some comfort from the fact that the country remained dollarized, but saw the prospect of strong FDI and Official Development Assistance as an opportunity to replenish coverage, while structural reforms would continue to enhance competitiveness in the nonresource sector. There was some discussion on the appropriate measurement of imports, with the level used by the IMF significantly higher (and reserve coverage correspondingly lower). They believed the current macroeconomic policy stance was sufficiently tight to reduce the kip's overvaluation further and contribute to external stability.

D. Fiscal Policy: Creating Buffers for Future Spending

Staff Views

22. Maintaining prudent fiscal policies will complement monetary tightening to contain overheating pressures. Staff viewed the current fiscal stance as broadly appropriate and welcomed the plan to scale back off-budget operations that commenced at the height of the previous global financial crisis.[5] The FY2013 budget deficit target is appropriate. However, staff urged that any

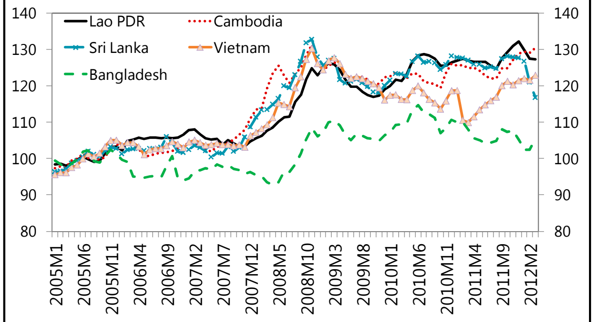
[5] Between 2002–07, the headline deficit averaged about 3 percent of GDP. A significant stimulus was implemented in 2009 that led to an increase in the deficit to close to 7 percent of GDP. Most was provided through the BoL, which disbursed funds directly to private contractors to finance local government's off-budget infrastructure projects. The authorities plan to issue bonds to clear about 20 percent of the stock of BoL lending (Kip 1,000 billion) and an additional Kip 200–300 billion to repay part of the SOCB recapitalization bonds.

Box 3. Exchange Rate Assessment

Staff estimates, using Lao-specific elasticities, present a mixed picture on the direction of misalignment, but on average suggest modest overvaluation. The exchange rate assessment indicates a degree of misalignment of the kip in the range of -19.9 to 31.2 percent. This range of overvaluation is lower than that in the 2011 staff assessment (between 8 and 42 percent)[1/]. The equilibrium exchange rate (EER) approach indicates an undervaluation of the kip. The different results from the last staff report reflect data revisions of the estimated net foreign assets for Lao P.D.R. as well as developments of the current account balance.

These estimates should be interpreted with caution. The margin of error can be large due to data limitations. In addition, it should be noted that some of the required adjustment in the external position will come about naturally, with current resource sector investments expected to lead to a significant boost in exports (mainly hydropower) after 2016, which is beyond the CGER exercise. Hence, these approaches may overestimate the needed adjustment in the exchange rate and therefore the misalignment of the kip.

Real Effective Exchange Rate, January 2005–March 2012
(2005=100)



Sources: Country authorities; and IMF staff estimates

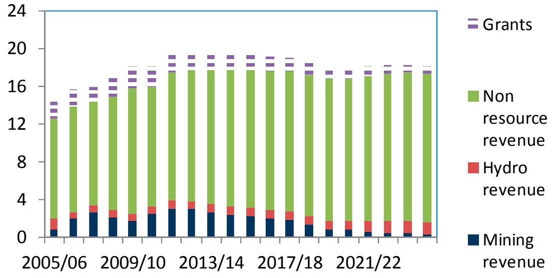
CGER Assessment of the Kip

Approach	Estimated Overvaluation (in percent)
Purchasing power parity	4.6
Macro balance	16.2 to 31.2
Equilibrium exchange rate	-19.9
External sustainability	10.4 to 17.6

Source: IMF staff estimates.

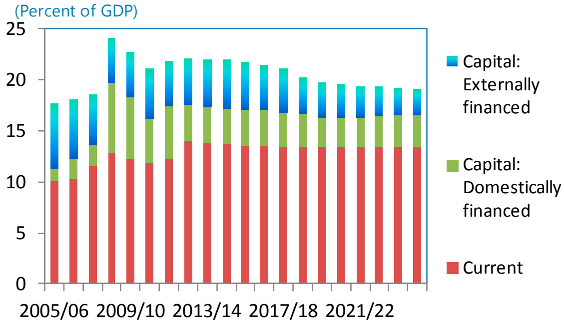
1/ See Box 4 in the 2011 Article IV consultation staff report.

Fiscal Revenue
(Percent of GDP)



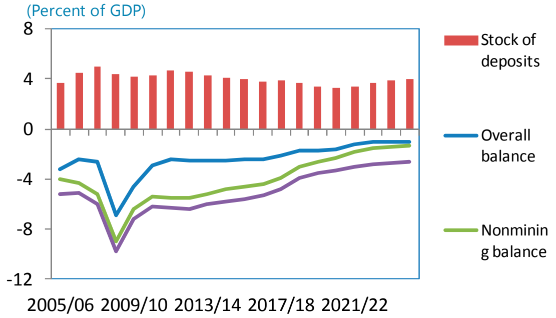
Sources: Country authorities; and IMF staff estimates

Fiscal Expenditure
(Percent of GDP)



Sources: Country authorities; and IMF staff estimates

Fiscal Balance and Government Deposits
(Percent of GDP)



Sources: Country authorities; and IMF staff estimates

revenue overperformance be saved and wage increases after FY2013 be more moderate to avoid undermining macroeconomic stability.[6]

Staff recognized the need to increase civil service wages to compensate for cost-of-living increases and maintain competitive pay with the private sector and supported the hiring of additional workers in social sectors (health care and education). However, the rapid, across-the-board increase in the civil service wage bill and allowances risks crowding out much needed, domestically-financed, public investment and could undermine macroeconomic stability, while earmarking of future revenue for this purpose should be avoided.

23. **For the medium term, staff noted that the government's domestic revenue goal of 16–17 percent of GDP required an additional tax effort of 1 percent of GDP,** which was viewed as achievable if the current strong revenue momentum is maintained despite declining mining revenue. However, the authorities would need to move forcefully on ongoing reforms of the tax system and avail themselves to TA, including that financed from the IMF' Management of Natural Resources Wealth Topical Trust Fund. In the event and assuming expenditure remains under control, the nonmining deficit, as the most appropriate fiscal target and anchor, would fall to below 5 percent of GDP by FY2015.[7]

24. **The external debt sustainability analysis suggests that Lao P.D.R. now faces a moderate risk of debt distress from a high risk previously**. The projected strong performance of the economy, fundamental improvements in institutional capacity, together with recent fiscal consolidation have

[6] The budget targets an across-the-board increase in wages by 37 percent and additional monthly allowances (about 0.9 percent of GDP each) with offsetting savings from phasing out off-budget capital spending and restraining other recurrent spending. The FY2013 budget was approved by the National Assembly in July 2012.

[7] See Box 3 in the Staff Report for the 2011 Article IV Consultation.

led to an upgrade in the country's risk rating and imply that debt indicators fall below indicative thresholds in the baseline. Staff welcomed the commitment to reduce public external debt to below 35 percent of GDP by 2015, which required appropriately tight macroeconomic policies so that inflation converges to key trading-partner levels to avoid nominal exchange rate depreciation. In this regard, it is also important to improve debt management capacity and develop a medium-term borrowing strategy for the government, including for resource sector activity, as well as to ensure greater disclosure of borrowing plans.

Authorities Views

25. The authorities emphasized their commitment to prudent fiscal policies and intent to build buffers to deal with future shocks. They agreed that any revenue overperformance next fiscal year (as well as underspending) and a higher share of mining revenue should be saved, for which they would establish a State Accumulation Fund to be managed by the newly established State Reserve Department within the Ministry of Finance. The reserve could be used in the event of natural disasters or if the need for counter-cyclical policies arises. The authorities also saw higher wages as necessary to compensate for cost of living increases and also contribute to improving governance. They recognized that the level of debt remains high but indicated that the debt service is relatively low due to its highly concessional nature. The authorities have put a ceiling on new debt commitments for nonself-financing expenditures equal to 25 percent of revenues, while borrowing for commercial projects would only be pursued if the internal rate of return exceeded 9.5 percent. The improved debt distress rating was welcomed as this reflected the country's strong performance and implied that the economy's absorptive capacity had improved.

BUILDING BROAD-BASED AND INCLUSIVE GROWTH

Staff Views

26. Lao P.D.R. is embarking on significant further trade integration, which should promote growth. The country will face increased competition following the phased mandatory reduction of tariffs under the ASEAN Free Trade Agreement. In addition, the government is embarking on revising relevant laws and passing implementing decrees in preparation for WTO accession.

27. Efforts to improve the business climate should be intensified. The latest World Bank Doing Business Survey (2012) suggests that Lao P.D.R. has made limited progress in streamlining business procedures and strengthening policy frameworks to boost private sector-led growth. Getting electricity, gaining access to credit, providing investor protections, and trading across borders are areas where much remains to be done. Ongoing efforts to improve the business climate and trade integration should be accelerated to support growth in the nonresource sector and achieve further poverty reduction (see Table 5 on the status of the MDGs in Lao P.D.R.).

28. Accelerating PFM reforms would contribute to achieving inclusive and sustainable growth, by improving the quality and transparency of spending and enhancing its prioritization to upgrade human and physical capital accumulation and poverty-reducing outlays. Priority reforms include improving government accounting and cash management and establishing a treasury single account, including through IMF TA.

29. Modernizing and upgrading the quality and comprehensiveness of economic data is becoming a more urgent priority as Lao P.D.R. develops. Data shortcomings hamper policy formulation, analysis, and surveillance, including the monitoring of emerging macroeconomic and financial risks and tracking progress made with achieving inclusive growth, including through poverty-reducing government expenditures.

Authorities Views

30. The authorities noted that reforms to improve the business climate had been accelerated. Commitments under the ASEAN Free Trade Agreement and the prospect of WTO accession had led to significant revisions to laws and the regulatory regime. These included efforts to streamline business registration procedures and the preparation of the Investment Promotion Law, while trade-related legislation is expected to be approved by the National Assembly by September. The authorities also noted that entry conditions for Lao P.D.R.'s accession to the WTO could be finalized by end-2012, noting the positive effect on exports and foreign investments in the medium-term. The authorities responded that they will consider requesting TA to address data shortcomings.

STAFF APPRAISAL

31. Lao P.D.R. continues to make impressive progress in developing its economy and reducing poverty. The authorities' policy management has been on the right track and is supporting confidence. Staff expect strong GDP growth in the coming years, inflation to remain manageable, modest fiscal deficits, and favorable debt dynamics. As a result, poverty incidence should continue to decline, with the country having generally good prospects to achieve the MDGs by 2015.

32. The benign outlook is subject to elevated, mainly home-grown downside risks, in particular from the rapid expansion of the banking sector. Spillover effects from the weak and uncertain global environment should be relatively modest, with the main channel of contagion through lower commodity prices. Instead, the main risk to macroeconomic stability stems from rapid credit growth in an environment of limited external and fiscal buffers to absorb potential domestic and external shocks and weak financial sector oversight.

33. A key policy challenge for the Lao P.D.R. authorities is to maintain macroeconomic stability and build broad-based and inclusive growth. Policies and institutional reforms will need to balance the objective of supporting growth in the near term with ensuring that development is sustainable by minimizing risks to macroeconomic stability. In this regard, the authorities should focus on further tightening monetary and fiscal policies and strengthening banking supervision, regulation, and enforcement, while continuing to improve the business climate to support growth in the nonresource sector and achieve further poverty reduction.

34. Monetary conditions need to be tightened. Policy tightening in recent years helped to contain inflation pressures and contributed to maintaining exchange rate stability. The increased credibility of monetary policy has allowed the authorities to partially liberalize foreign exchange transactions. With inflation manageable, the BoL's policies should be focused on phasing out quasi-fiscal operations and further reducing the pace of monetary expansion through stepped-up sterilization and higher reserve requirements. Tensions that result from the pursuit of multiple monetary policy objectives may have contributed to the low reserves cushion, thus ultimately undermining the main anchor (a stabilized exchange rate). Further improvements to the policy framework would include improving the compilation of monetary statistics to enhance liquidity forecasting and foreign exchange cash-flow projections. Over the medium-term, an explicit inflation target range could be adopted, which would enhance the effectiveness of monetary policy by anchoring inflation expectations, in the context of also improving the monetary transmission mechanism.

35. Banking supervision should be strengthened to maintain financial sector stability. Staff urged the authorities' continued attention to maintaining the quality of credit and to ensure that the pace of financial deepening is consistent with improvements in regulatory and supervisory enforcement capacity, while the prudential toolkit should also be strengthened.

36. Reserve levels are well below standard precautionary metrics and need to be replenished. International reserves provide a cushion against shocks, but current levels of protection are inadequate. Staff were encouraged by the authorities' intent to replenish reserve buffers in the near future by pursuing tighter macroeconomic policies to slow down import growth, and also to take advantage of the prospect of strong capital inflows in the coming years. The staff estimates the real effective exchange rate on average to be modestly overvalued compared to medium term fundamentals, but less so than in the past.

37. The fiscal stance is appropriate, but large civil service wage increases should be reconsidered. The deficit target in FY2013, under generally more efficient and transparent budget processes, is supportive of macroeconomic stability provided any revenue overperformance is saved and new off-budget spending is avoided. Medium-term fiscal goals also seem broadly appropriate, focused around reducing the nonmining deficit to below 5 percent of GDP. In this regard, staff are encouraged by the intention of the authorities to establish a reserve funded mainly by excess revenues. This will strengthen the ability of the budget to respond to future shocks, including natural disasters. However, the reorientation of expenditure towards civil servant wages could crowd out higher priority spending.

38. Staff support the authorities' intention to build broad-based and inclusive growth. The authorities efforts under the umbrella of WTO accession and the ASEAN Free Trade Agreement is paving the way for an improved business climate that will enhance the competitiveness of the nonresource sector. Accelerating PFM reforms would contribute to achieving inclusive and sustainable growth by improving the quality, transparency, and prioritization of spending.

39. The IMF stands prepared to support the government's reform efforts through more intensive TA, focused on improving financial sector supervision, enhancing the monetary policy framework, and strengthening revenue administration, including through the recently established TA office for Lao P.D.R. and Myanmar in Bangkok.

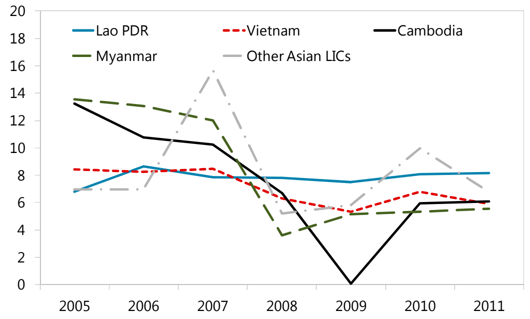
40. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Lao P.D.R.: Real and External Sector Developments and Outlook

Lao P.D.R's growth record has been impressive in recent years, however, diversifying growth remains a challenge.

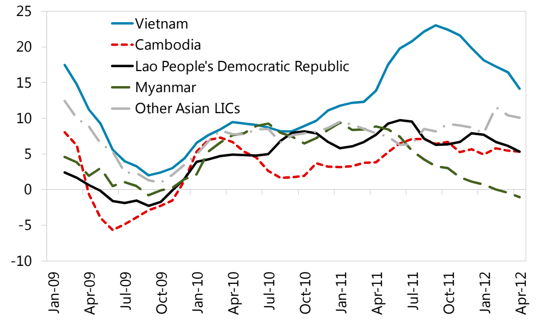
Growth has been strong and more stable compared to other LICs in Asia.

GDP Growth in Asian Low Income Countries
(In percent)



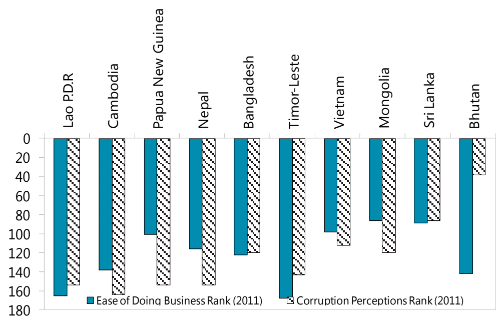
Inflation has largely been contained below 10 percent even as major commodity price shocks hit.

Headline Inflation in Asian LICs
(In percent y/y)



However, Lao PD.R. fairs poorly compared to other LICs on business-climate indicators...

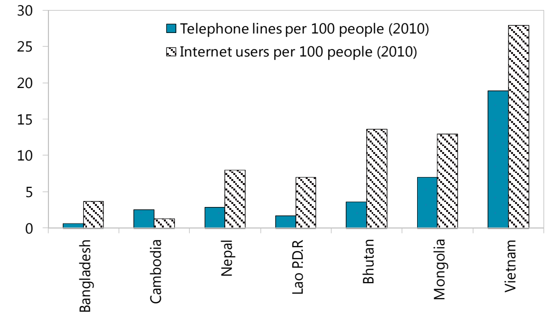
Hindrance to Investment
(International rankings)



Sources: WDI and Transparency International

...and infrastructure needs to be improved to help diversify growth beyond the resource sector.

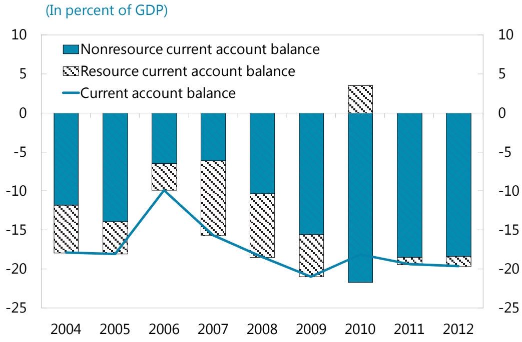
Infrastructure



Sources: WDI and Transparency International

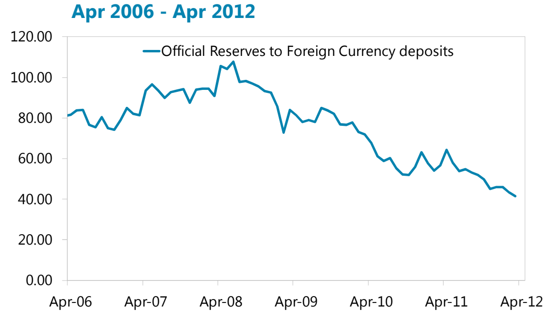
The nonresource current account deficit is estimated to have narrowed in 2011, partly reflecting the tightening of domestic policies.

Current Account Balance
(In percent of GDP)



However, the coverage of official reserves has declined in recent years.

Official Reserves to Foreign Currency deposits Apr 2006 - Apr 2012



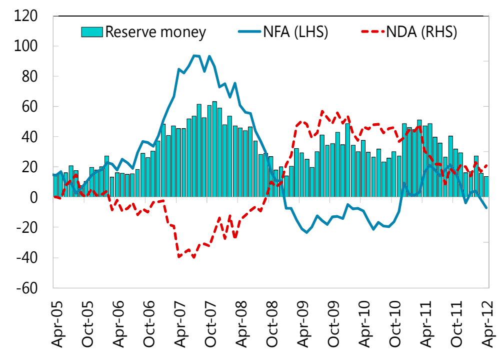
Sources: Country authorities; and IMF staff estimates

Figure 2. Lao P.D.R.: Monetary Developments

The decline in reserve money over the past year reflects lower gross international reserves.

Contribution to Reserve Money Growth, Apr 2005–Apr.2012

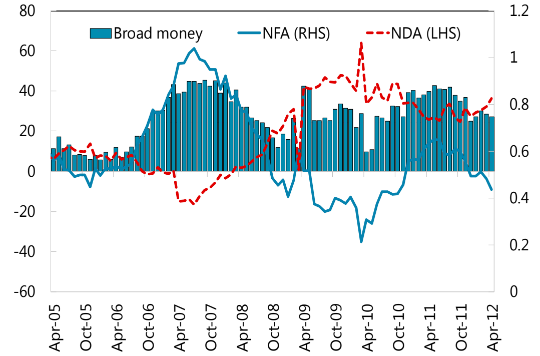
(Year-on-year percentage change)



While broad money slowed in 2011, the trend reverted in the first quarter of 2012...

Contribution to Broad Money Growth,Apr.2005–Apr.2012

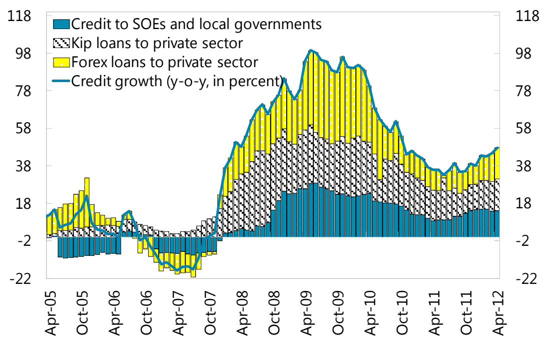
(Year-on-year percentage change)



... as credit growth has picked up again in recent months.

Contribution to Credit Growth, Apr.2005-Apr.2012

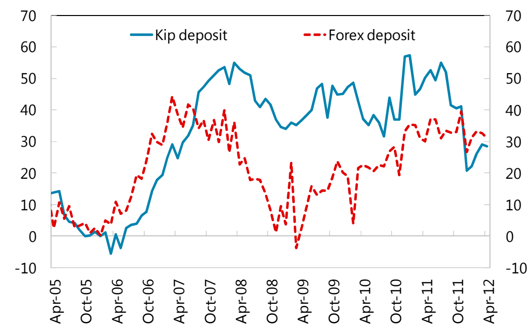
(Year-on-year percent change)



While growth in foreign currency deposits remained strong, kip deposits' growth has slowed somewhat.

Deposit Growth, Apr.2005-Apr.2012

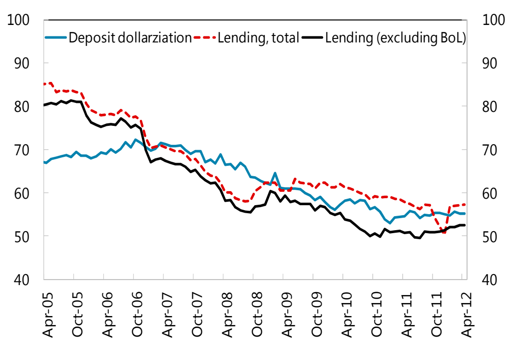
(Year-on-year percentage change)



With the increase in foreign currency deposits, deposit dollarization rose somewhat.

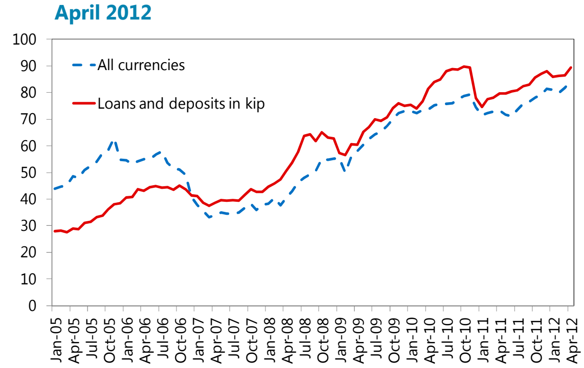
Dollarization, Apr.2005–Apr.2012

(In percent)



Overall, the ratio of loans to deposits increased.

Comercial Bank's Loan to Deposit Ratio, January 2005-April 2012



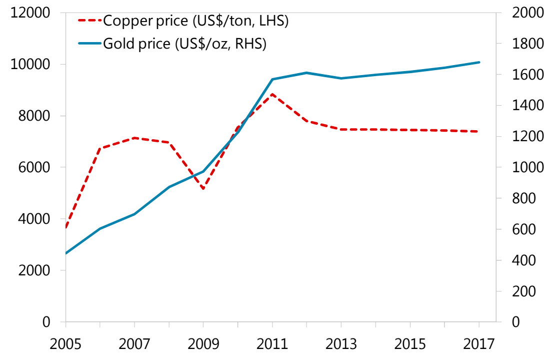
Sources: Country authorities, and IMF staff estiamtes

Figure 3. Lao P.D.R.: Resource Sector Developments and Outlook

The resource sectors have grown rapidly, providing a significant contribution to exports and fiscal revenue. However, based on current plans for new mining developments, their contribution is expected to decline in the medium term.

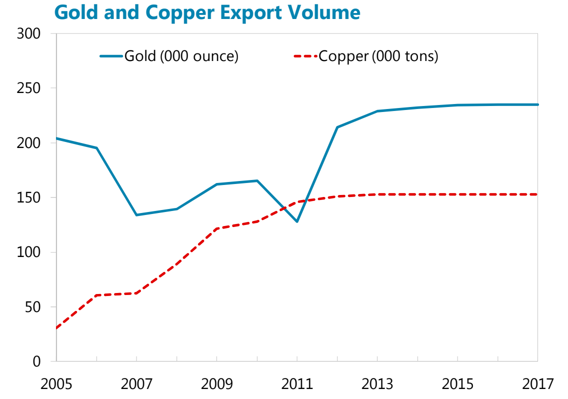
Copper and gold prices are exceptionally high and expected to remain strong.

Copper and Gold Price



The medium-term prospect for mining production is favorable owing to recent expansion.

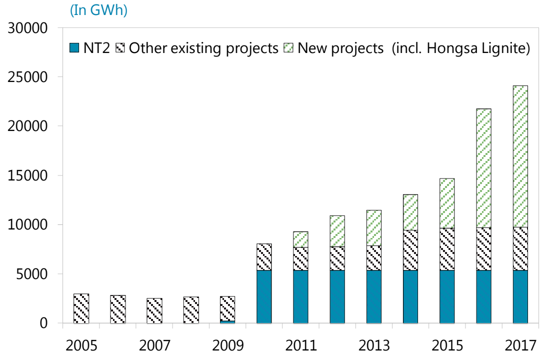
Gold and Copper Export Volume



Hydro electric exports would increase substantially with the operation of new dams in the medium term.

Hydro Electric Export Volume

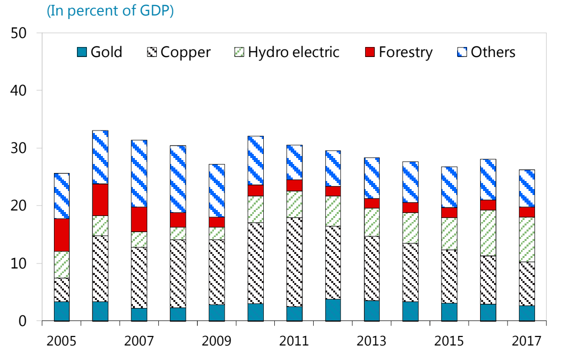
(In GWh)



The resource sectors provide a large contribution to exports, but their role is expected to decline in the near future.

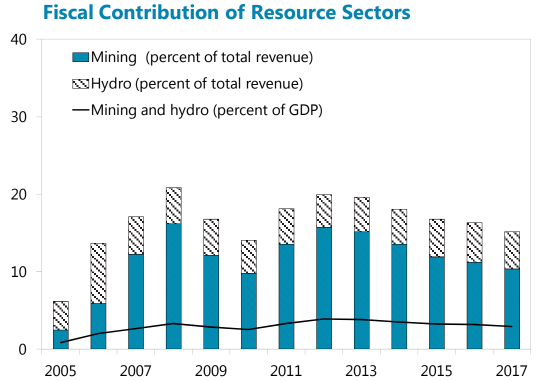
Export of Resource and Nonresource Sectors

(In percent of GDP)



The fiscal contribution of the resource sectors remains large, but is also projected to decline in the medium term.

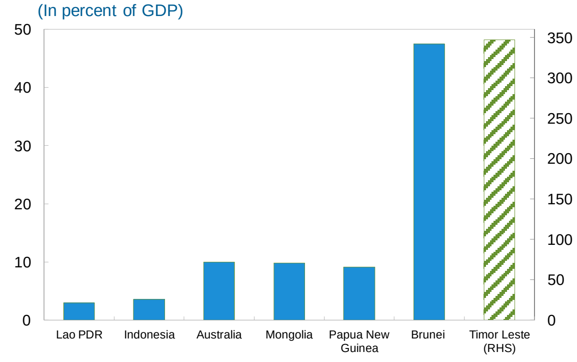
Fiscal Contribution of Resource Sectors



Nevertheless, the size of resource revenue is relatively small compared to other countries in the region.

Revenue from Natural Resources, 2006-11

(In percent of GDP)



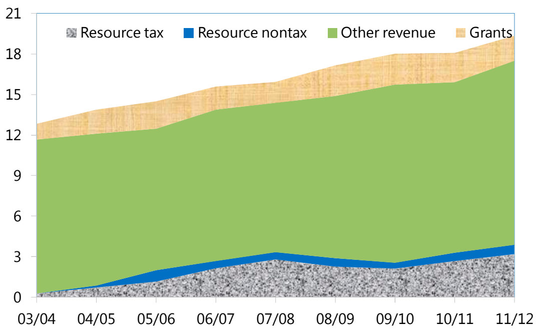
Sources: Country authorities; and IMF staff estimates

Figure 4. Lao P.D.R.: Fiscal Sector Developments and Outlook

Fiscal performance has improved since 2009 owing to strong revenue collections and restrained spending. The near-term outlook is also favorable with continued fiscal consolidation and a comfortable level of government deposits.

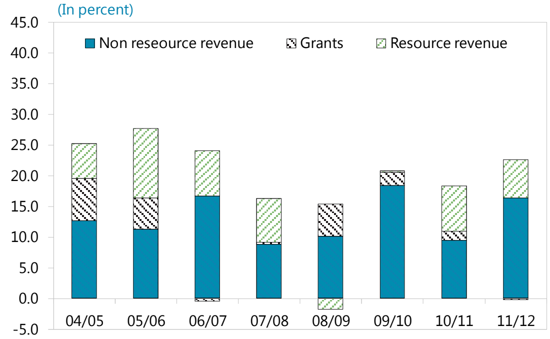
Strong resource revenue has helped sustain the growth of overall revenue despite lower grant disbursement.

Goverment Revenue and Grants
(in percent of GDP)



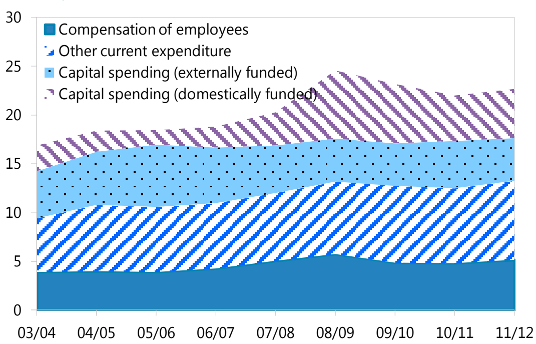
While the introduction of VAT has also improved the collection of nonresource revenue since 2010.

Contribution to Revenue Growth
(In percent)



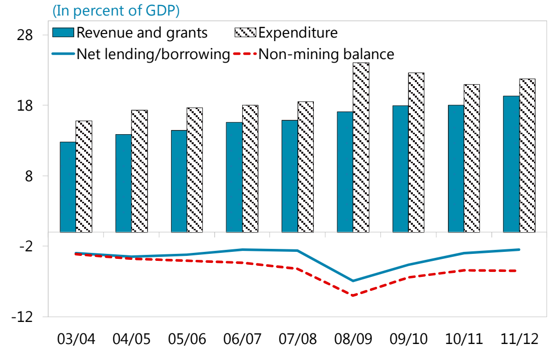
Spending has been restrained, particularly domestic capital expenditure including off-budget operations.

Government Expenditure
(In percent of GDP)



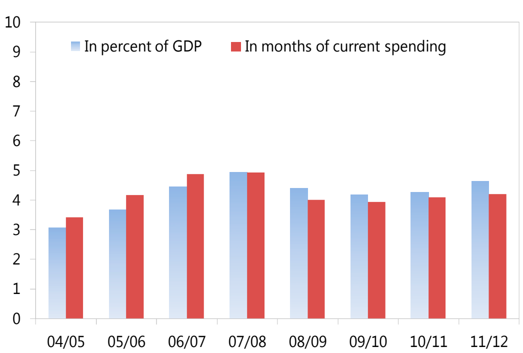
As a result, the fiscal deficit has narrowed remarkably since 2009.

Fiscal Balance
(In percent of GDP)



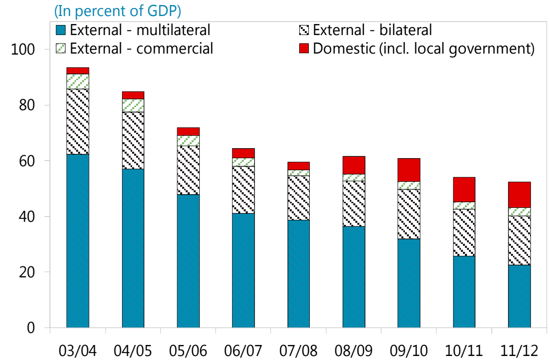
The stock of government deposits remains comfortable...

Stock of Government Deposits



...and public domestic debt is on a downward trend despite the increase in BoL lending to local governments.

Public Sector Debt
(In percent of GDP)



Sources: Country authorities; and IMF staff estimates

Table 1. Lao P.D.R.: Medium-Term Macroeconomic Framework, 2009–17

	2009	2010	2011 Est.	2012	2013	2014	2015	2016	2017
				Projections					
Output and prices	(Percent change, unless otherwise indicated)								
Real GDP	7.5	8.1	8.0	8.3	8.0	7.7	7.8	7.9	7.8
Real GDP (excluding resource projects)	4.7	6.7	7.2	7.5	7.4	7.4	7.5	7.5	7.5
Consumer prices (end-period)	3.9	5.8	7.7	5.3	6.2	4.9	4.5	4.2	4.2
Consumer prices (annual average)	0.0	6.0	7.6	5.1	6.8	4.8	4.7	4.3	4.2
GDP per capita (in U.S. dollars)	886	1,064	1,265	1,386	1,507	1,614	1,740	1,876	2,024
Public finances (in percent of GDP) 1/									
Revenue	17.1	18.0	18.1	19.3	19.5	19.4	19.4	19.3	19.1
Tax and nontax revenue	14.9	15.7	15.9	17.5	17.7	17.7	17.7	17.7	17.5
Mining	2.1	1.8	2.4	3.1	3.0	2.6	2.3	2.2	2.0
Hydro power	0.8	0.8	0.8	0.8	0.9	0.9	0.9	1.0	0.9
Others	12.0	13.2	12.6	13.6	13.9	14.2	14.4	14.5	14.6
Grant	2.3	2.3	2.2	1.9	1.8	1.7	1.7	1.6	1.5
Expenditure	24.1	22.7	21.0	21.8	22.1	21.9	21.9	21.7	21.5
Expense	12.9	12.3	12.0	12.3	14.0	13.8	13.7	13.5	13.5
Net acquisition of nonfinancial assets 2/	11.2	10.4	9.1	9.5	8.1	8.2	8.2	8.2	7.9
Net lending/borrowing	-6.9	-4.6	-3.0	-2.5	-2.5	-2.5	-2.5	-2.4	-2.4
Nonmining balance 3/	-9.0	-6.4	-5.4	-5.5	-5.5	-5.2	-4.8	-4.6	-4.4
Balance of payments	(In millions of U.S. dollars; unless otherwise indicated)								
Current account balance	-1,174	-1,256	-1,773	-2,026	-2,464	-2,683	-2,661	-2,196	-2,268
In percent of GDP	-21.0	-18.3	-21.4	-21.9	-24.0	-23.9	-21.6	-16.2	-15.3
Exports	1,521	2,196	2,529	2,737	2,902	3,094	3,285	3,798	3,894
Of which: Resources	912	1,500	1,884	2,018	2,020	2,120	2,217	2,607	2,685
In percent change	-5.5	44.4	15.2	8.2	6.0	6.6	6.2	15.6	2.5
Of which: Resources	5.4	64.5	25.6	7.2	0.1	5.0	4.6	17.6	3.0
Imports	2,893	3,582	4,603	5,202	5,955	6,451	6,626	6,581	6,813
In percent change	2.0	23.8	28.5	13.0	14.5	8.3	2.7	-0.7	3.5
Of which: Resources	-9.9	-18.6	100.1	16.6	27.2	3.8	-7.4	-11.9	-17.0
Services and income (net)	65	-49	86	200	324	385	362	237	282
Transfers	133	179	216	239	264	289	318	350	370
Capital account balance	1,094	1,359	1,728	2,075	2,525	2,799	2,808	2,489	2,625
Of which: FDI	759	671	1,210	1,399	1,836	1,990	1,890	1,653	1,835
Overall balance	-80	102	-45	49	61	116	147	293	357
Debt and debt service									
Public debt (in percent of GDP)	62.4	59.6	52.8	52.2	50.5	49.5	48.5	47.4	46.1
External debt (in percent of GDP)	102.3	87.1	82.8	87.8	94.6	102.2	102.1	97.3	92.1
External public debt (in percent of GDP)	56.0	50.3	44.3	43.8	43.1	42.7	42.4	41.9	41.2
External public debt service (in percent of exports)	4.9	4.3	3.2	4.7	4.6	4.7	4.8	4.5	4.6
Gross official reserves									
In millions of U.S. dollars	633	728	677	723	780	892	1,035	1,325	1,678
In months of imports (excluding resource projects)	2.5	2.6	2.2	2.1	2.1	2.2	2.4	2.8	2.9
Memorandum items:									
Nominal GDP (in billions of kip)	47,562	56,523	66,515	75,383	86,736	98,153	110,944	124,997	140,701

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.

1/ Fiscal year basis (October to September).
2/ Includes off-budget investment expenditures.
3/ Net lending/borrowing minus mining revenue.

Table 2. Lao P.D.R.: Balance of Payments, 2009–13

	2009	2010	2011	2012	2013
			Est.	Projection	
	(In millions of U.S. dollars; unless otherwise indicated)				
Current account	-1,174	-1,256	-1,773	-2,026	-2,464
Merchandise trade balance	-1,372	-1,386	-2,074	-2,465	-3,052
Exports, f.o.b.	1,521	2,196	2,529	2,737	2,902
Mining and hydropower	912	1,500	1,884	2,018	2,020
Other exports	609	696	645	719	882
Imports, c.i.f.	2,893	3,582	4,603	5,202	5,955
Mining and hydropower	895	728	1,457	1,698	2,161
Mining projects	260	354	445	537	527
Hydropower projects	635	374	1,012	1,161	1,634
Petroleum imports	291	412	583	605	602
Other imports	1,707	2,442	2,563	2,898	3,191
Services (net)	330	376	441	516	586
Of which: Tourism	268	383	448	525	603
Income (net)	-265	-425	-356	-316	-262
Interest payments	-81	-135	-115	-147	-141
Of which: Public	-27	-41	-27	-59	-62
Mining and hydropower	-41	-86	-82	-81	-71
Mining projects	-29	-6	-10	-14	-10
Hydropower projects	-12	-79	-72	-67	-61
Dividends and profit repatriation	-322	-525	-651	-550	-507
Of which: Mining and hydropower	-279	-470	-596	-494	-449
Other	137	235	410	381	385
Transfers (net)	133	179	216	239	264
Private	35	70	84	92	102
Official	97	109	132	147	163
Capital and financial account	1,094	1,359	1,728	2,075	2,525
Public sector	162	155	145	308	340
Disbursements	229	231	220	412	451
Amortization	-67	-77	-74	-104	-111
Banking sector (net)	140	-26	-17	-10	-10
Private sector	792	1,230	1,600	1,776	2,195
Foreign direct investment (net) 1/	759	671	1,210	1,399	1,836
Of which: Mining and hydropower projects	704	250	783	969	1,343
Of which: Mining projects	20	-37	102	94	81
Hydropower projects	684	287	681	875	1,262
Other private flows and errors and omissions	33	559	390	378	359
Overall balance	-80	102	-45	49	61
Core Balance (CA+FDI+ODA)	-253	-431	-465	-362	-331
Financing	80	-102	45	-49	-61
Central bank net foreign assets	80	-102	45	-49	-61
Assets (increase -)	6	-95	51	-45	-58
Liabilities (reduction -)	74	-7	-6	-4	-4
Memorandum items:					
Current account balance (in percent of GDP)	-21.0	-18.3	-21.4	-21.9	-24.0
Excluding official transfers	-22.7	-19.9	-22.9	-23.4	-25.6
Resource current account balance (in percent of GDP) 2/	-5.4	3.2	-3.0	-2.7	-6.4
Nonresource current account balance (in percent of GDP)	-15.6	-21.5	-18.3	-19.1	-17.6
Exports (annual percent change)	-5.5	44.4	15.2	8.2	6.0
Mining and hydropower	5.4	64.5	25.6	7.2	0.1
Other exports	-18.1	14.3	-7.2	11.4	22.7
Imports (annual percent change)	2.0	23.8	28.5	13.0	14.5
Of which: Hydropower and mining related	-9.9	-18.6	100.1	16.6	27.2
Gross official reserves	633	728	677	723	780
In months of prospective imports of goods and nonfactor services	2.0	1.8	1.5	1.4	1.4
(Excluding imports associated with large resource projects)	2.5	2.6	2.2	2.1	2.1
Nominal GDP at market prices	5,597	6,855	8,302	9,269	10,270

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.

1/ Includes repayment of private debt. FDI in the balance of payments includes both equity and debt, whereas only the nondebt portion is included in the debt sustainability analysis.
2/ Pertains to large mining and hydropower (resource) projects.

Table 3. Lao P.D.R.: General Government Operations, 2009/10–2012/13

	2009/10	2010/11 Rev. Budget	2010/11 Est.	2011/12 Rev. Budget	2011/12 Proj.	2012/13 Prel. Budget	2012/13 Proj.
	(In billions of kip)						
Revenue	9,779	10,517	11,571	12,509	14,156	16,371	16,382
Of which: Resource revenue 1/	1,376	...	2,097	...	2,824	...	3,211
Taxes	7,503	8,287	9,109	10,058	11,457	13,383	13,389
Income and profit taxes	1,587	1,961	2,136	2,503	3,023	...	3,724
Income taxes	462	486	543	500	678	...	787
Profit taxes	1,125	1,474	1,592	2,003	2,345	...	2,937
Of which: Mining	487	783	888	...	1,365	...	1,682
Of which: Nonmining	638	691	705	...	980	...	1,255
VAT	1,869	2,028	2,403	2,240	2,997	...	3,474
Excise duties	1,687	1,832	1,948	2,166	2,294	...	2,619
Import duties	832	1,010	965	1,208	1,170	...	1,343
Royalties	560	607	722	894	908	...	1,016
Other taxes	968	849	936	1,047	1,063	...	1,214
Other revenues	1,035	1,042	1,073	1,282	1,340	1,550	1,465
Grants	1,242	1,188	1,389	1,169	1,359	1,438	1,528
Expenditure	12,302	12,339	13,461	14,497	15,959	17,417	18,513
Expense	6,656	7,786	7,652	9,112	9,008	11,816	11,742
Compensation of employees	2,525	2,947	2,940	3,450	3,450	4,677	4,677
Transfers	1,698	1,917	1,866	2,131	2,129	3,191	3,191
Interest payments	398	498	431	553	530	961	899
Of which: External	318	427	373	432	409	611	470
Other recurrent	2,034	2,424	2,415	2,979	2,899	2,988	2,975
Net acquisition of nonfinancial assets	5,646	4,553	5,808	5,385	6,951	5,601	6,772
Domestically financed	3,271	1,703	2,699	2,640	3,740	2,600	2,989
Of which: Off-budget	1,823	...	1,130	...	1,100	...	400
Externally financed	2,376	2,850	3,109	2,744	3,211	3,001	3,783
Net lending/borrowing	-2,524	-1,822	-1,889	-1,987	-1,803	-1,046	-2,131
Net acquisition of financial assets	53	...	302	...	759	...	8
Domestic	53	...	302	...	759	...	8
Foreign	0	...	0	...	0	...	0
Net incurrence of liabilities	2,565	...	2,328	...	2,562	...	2,139
Domestic	1,714	...	1,066	...	1,100	...	400
Foreign	851	1,155	1,262	966	1,462	797	1,739
Discrepency	11	...	-136	...	0	...	0
Memorandum items:							
Nonmining balance 2/	-3,478	...	-3,456	...	-4,035	...	-4,619
Operating balance	3,123	...	3,919	...	5,148	...	4,641
Mining revenue	954	...	1,567	...	2,232	...	2,489
Hydropower revenue	422	...	530	...	592	...	722
Nonresource revenue	7,161	...	8,086	...	9,973	...	11,643
GDP	54,283	64,017	64,017	73,166	73,166	83,898	83,898

Table 3. Lao P.D.R.: General Government Operations, 2009/10–2012/13 (concluded)

	2009/10	2010/11		2011/12		2012/13	
		Budget	Est.	Rev. Budget	Proj.	Prel. Budget	Proj.
	(In percent of GDP, unless otherwise indicated)						
Revenue	18.0	16.4	18.1	17.1	19.3	19.5	19.5
Of which: Resource revenue 1/	2.5	...	3.3	...	3.9	...	3.8
Nonrenewable resources	1.8	...	2.4	...	3.1		3.0
Renewable resources	0.8	...	0.8	...	0.8		0.9
Nonresource revenue	13.2	...	12.6	...	13.6		13.9
Taxes	13.8	12.9	14.2	13.7	15.7	16.0	16.0
Income and profit taxes	2.9	3.1	3.3	3.4	4.1	...	4.4
Income taxes	0.9	0.8	0.8	0.7	0.9	...	0.9
Profit taxes	2.1	2.3	2.5	2.7	3.2	...	3.5
Of which: Mining	0.9	1.2	1.4	...	1.9	...	2.0
Of which: Nonmining	1.2	1.1	1.1	...	1.3	...	1.5
VAT	3.4	3.2	3.8	3.1	4.1	...	4.1
Excise duties	3.1	2.9	3.0	3.0	3.1	...	3.1
Import duties	1.5	1.6	1.5	1.7	1.6	...	1.6
Royalties	1.0	0.9	1.1	1.2	1.2	...	1.2
Other revenues	1.9	1.6	1.7	1.8	1.8	1.8	1.7
Grants	2.3	1.9	2.2	1.6	1.9	1.7	1.8
Expenditure	22.7	19.3	21.0	19.8	21.8	20.8	22.1
Expense	12.3	12.2	12.0	12.5	12.3	14.1	14.0
Compensation of employees	4.7	4.6	4.6	4.7	4.7	5.6	5.6
Transfers	3.1	3.0	2.9	2.9	2.9	3.8	3.8
Interest payments	0.7	0.8	0.7	0.8	0.7	1.1	1.1
Of which: External	0.6	0.7	0.6	0.6	0.6	0.7	0.6
Other recurrent	3.7	3.8	3.8	4.1	4.0	3.6	3.5
Net acquisition of nonfinancial assets	10.4	7.1	9.1	7.4	9.5	6.7	8.1
Domestically financed	6.0	2.7	4.2	3.6	5.1	3.1	3.6
Of which: Off-budget	3.4	...	1.8	...	1.5	...	0.5
Externally financed	4.4	4.5	4.9	3.8	4.4	3.6	4.5
Net lending/borrowing	-4.6	-2.8	-3.0	-2.7	-2.5	-1.2	-2.5
Net acquisition of financial assets	0.1	...	0.5	...	1.0	...	0.0
Domestic	0.1	...	0.5	...	1.0	...	0.0
Foreign	0.0	...	0.0	...	0.0	...	0.0
Net incurrence of liabilities	4.7	...	3.6	...	3.5	...	2.5
Domestic	3.2	...	1.7	...	1.5	...	0.5
Foreign	1.6	1.8	2.0	1.3	2.0	0.9	2.1
Discrepency	0.0	...	-0.2	...	0.0	...	0.0
Memorandum items:							
Nonmining balance 2/	-6.4	...	-5.4	...	-5.5	...	-5.5
Operating balance	5.8	...	6.1	...	7.0	...	5.5
Mining revenue	1.8	...	2.4	...	3.1	...	3.0
Hydropower revenue	0.8	...	0.8	...	0.8	...	0.9
Nonresource revenue	13.2	...	12.6	...	13.6	...	13.9
GDP	54,283	64,017	64,017	73,166	73,166	83,898	83,898

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.

1/ Resource revenue comprises royalties, taxes, and dividends from the mining and hydropower sectors.
2/ Net lending/borrowing minus mining revenues.

Table 4. Lao P.D.R.: Monetary Survey 2009–13

	2009	2010		2011		2012			2013
	Dec.	Sep.	Dec.	Sep.	Dec.	Mar.	Sep.	Dec.	Dec.
							Projection		
	(In billions of kip, unless otherwise indicated)								
Bank of Lao P.D.R. (BoL)									
Net foreign assets	4,555	3,588	5,151	5,129	4,772	4,727	5,074	5,175	5,671
In millions of U.S. dollars	537	442	639	640	595	593	614	626	657
Net domestic assets	1,880	3,571	4,409	4,924	6,341	7,394	7,572	7,785	8,287
Government (net)	-815	-915	-742	-719	-653	43	-716	-653	-200
Claims	925	719	926	669	688	883	671	689	1,189
Deposits	-1,740	-1,634	-1,667	-1,387	-1,341	-840	-1,387	-1,341	-1,389
Of which: Foreign currency	-1,143	-1,022	-1,243	-932	-1,091	-618	-1,010	-976	-1,011
State-owned enterprises	2,312	3,319	3,367	4,450	4,997	5,228	5,550	5,400	4,950
Of which: Kip	373	408	419	943	1,254	1,347	1,393	1,356	609
Local governments	2,017	3,024	3,071	4,154	4,701	4,932	5,254	5,104	4,654
Banks	1,173	1,701	1,936	2,606	3,168	3,188	3,768	3,968	4,468
BoL securities	-660	-908	-1,023	-2,288	-2,145	-2,003	-2,003	-2,003	-2,003
Other items (net)	-129	374	872	876	974	938	974	1,073	1,073
Reserve money	6,436	7,159	9,560	10,053	11,113	12,120	12,646	12,960	13,958
Currency in circulation	3,580	3,720	4,505	5,053	5,661	5,777	6,559	6,721	6,825
Bank reserves (kip)	1,211	1,583	3,013	3,574	3,788	4,594	4,311	4,418	4,759
Of which: Capital deposits	168	346	511	561	825	608	731	749	1,036
Bank reserves (foreign currency)	1,644	1,856	2,039	1,427	1,663	1,749	1,776	1,820	2,375
Monetary survey									
Net foreign assets	5,500	4,280	6,259	6,285	5,747	6,592	6,141	6,263	6,893
In millions of U.S. dollars	648	527	777	784	716	826	743	758	799
Of which: Commercial banks	111	85	137	144	122	234	129	132	142
Net domestic assets	9,678	13,560	14,856	18,281	20,623	21,823	24,842	26,785	32,925
Government (net)	-627	-774	-420	-1,292	-1,209	-964	-1,289	-1,209	-256
Budget	-1,215	-1,361	-1,008	-1,879	-1,797	-1,551	-1,877	-1,796	-644
Claims	1,080	907	1,390	843	884	1,662	923	884	2,084
Deposits	-2,294	-2,269	-2,398	-2,722	-2,681	-3,213	-2,800	-2,680	-2,728
Other	588	588	588	588	588	588	588	588	388
Credit to the economy	11,143	14,805	16,270	19,949	22,478	24,489	27,835	29,697	34,885
In kip	4,195	6,146	6,659	8,553	9,749	10,489	11,412	12,176	14,303
In foreign currencies	6,948	8,659	9,611	11,396	12,729	14,000	16,422	17,521	20,582
Of which: Private credit	8,565	11,212	12,315	14,672	16,117	17,877	20,292	21,436	27,224
Other items (net)	-838	-471	-994	-376	-646	-1,703	-1,703	-1,703	-1,703
Broad money	15,177	17,841	21,114	24,566	26,370	28,415	30,984	33,048	39,818
Currency in circulation	3,086	3,029	3,791	4,322	4,897	4,858	5,057	5,720	6,681
Kip deposits	5,100	6,482	8,012	9,174	9,671	10,566	11,463	12,157	15,106
Foreign currency deposits (FCDs)	6,992	8,330	9,312	11,070	11,803	12,991	14,464	15,171	18,032
	(Annual percent change, unless otherwise indicated)								
Reserve money	25.1	25.9	48.6	40.4	16.2	15.8	25.8	16.6	7.7
Broad money	31.2	32.3	39.1	37.7	24.9	28.5	26.1	25.3	20.5
Of which: Net domestic assets	130.7	77.2	53.5	34.8	38.8	48.4	35.9	29.9	22.9
Credit to the economy	90.7	61.7	46.0	34.7	38.2	44.8	39.5	32.1	17.5
Credit to the private sector	88.1	55.8	43.8	30.9	30.9	41.3	38.3	33.0	27.0
Memorandum items:									
Velocity	3.1	3.0	2.7	2.6	2.5	2.7	2.4	2.3	2.2
Loan/deposit (percent)	73.0	77.5	74.5	76.6	81.4	81.8	86.0	88.9	90.3
In kip (percent)	74.9	88.5	77.9	82.9	87.8	86.5	87.4	89.0	90.7
In foreign currency (percent)	71.6	69.0	71.6	71.3	76.1	77.9	84.8	88.8	90.1
Gross official reserves (in millions of U.S. dollars)	633	530	728	724	677	675	723	723	780
Net international reserves (in millions of U.S. dolla	343	213	386	462	387	373	399	406	382
Exchange rate, end-of-period (kip per U.S. dollar)	8,481	8,120	8,058	8,020	8,023	7,976	8,264	8,264	8,627
Nominal GDP (in billions of kip)	47,562	54,283	56,523	64,017	66,515	75,383	73,166	75,383	86,736
Dollarization rate (FCDs/broad money; in percent)	46.1	46.7	44.1	45.1	44.8	45.7	46.7	45.9	45.3
Gross reserve/Reserve Money	83	60	61	58	49	44	47	46	48
Excess reserves in kip	956	1,258	2,612	3,115	3,305	4,066	3,738	3,810	4,003
Excess reserves in foreign currency	945	1,023	1,108	320	483	450	330	303	572

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates.

1/ Defined as gross official reserves minus BoL foreign liabilities and the foreign exchange component of reserve money.

Table 5. Millennium Development Goals: Progress in Lao P.D.R

MDGs	Indicator	Baseline	Current Status	2015 Target
1: Eradicate extreme poverty and hunger	Proportion of population below the national poverty line	46	26.8	24
	Employment-to-population ratio	47	49	No target
	Prevalence of underweight children under five years of age	44	37	22
	Prevalence of stunting in children under five years of age	48	40	34
2: Achieve universal primary Education	Proportion of pupils starting grade 1 who reach grade 5	48	67	95
	Literacy rate in the age group of 15–24 years	71	84	99
3: Promote gender equality and empower Women	Number of girls per 100 boys enrolled in:			
	Primary	77	86	100
	Lower secondary	66	78	100
	Upper secondary	56	74	100
	Tertiary	49	62	100
	Share of women in wage employment	38	50	No target
4: Reduce child mortality	Under–five mortality rate	170	98	55
	Proportion of one-year-old children immunized against measles	41.8	40.4	90
5: Improve maternal Health	Proportion of births attended by skilled birth personnel	14	23	49
	Maternity mortality rate (per 100,000 live births)	…	405	80
6: Combat HIV/AIDS, malaria and other diseases	HIV prevalence among general pop. (percentage)	0.006	0.1	less than 1
7: Ensure Environmental Sustainability	Proportion of land areas covered by forests (percentage)	70	42	65
	CO2 emissions and consumption of ozone-depleting substances (mt)	50	18	No target

Source: United Nations, "Accelerating Progress Towards the MDGs"; and Lao P.D.R, "The Seventh Five-year National Socio-Economic Development Plan (2011–2015)."
(http://www.unlao.org/mediaandpub/publications/2010/MAF%20Report_Lao%20PDR_September%202010.pdf).

Table 6. Lao P.D.R.: Financial Soundness Indicators, 2007–11

	2007	2008	2009	2010	2011
Captal adequacy ratio (Basel I)	...	25.0	20.1	21.6	...
State-owned commercial banks (SOCBs)	...	1.7	3.8	4.8	6.0
Joint-venture banks	...	30.6	9.0	9.9	...
Foreign bank branches	...	26.2	34.0	37.7	...
Private banks	...	41.5	33.5	34.1	...
NPL ratio	5.9	5.4	3.8	3.8	2.2
State-owned commercial banks	4.2	1.7	1.3	1.5	...
Joint-venture banks	12.7	4.5	1.3	1.6	...
Foreign bank branches	0.6	13.9	10.5	10.8	...
Private banks	...	1.4	1.9	1.2	...
Return on assets (select SOCBs only) 1/	0.9	3.1	...	...	...
Banque pour le Commerce Exterieur Lao	4.7	3.6	...	3.1	3.2
Lao Development Bank	0.8	2.2	...	...	...
Agricultural Promotion Bank	-2.8	3.6	...	...	...
Number of banks	13	20	23	25	25
State-owned commercial banks	4	4	4	4	4
Joint-venture banks	2	2	2	2	2
Foreign bank branches	6	9	10	11	11
Private banks	1	5	7	8	8
Sectoral allocation of bank credit (in percent of total)					
Industry and handicraft	22	19	19	19	20
Construction	4	4	4	12	13
Materials and technical supplies	8	9	8	5	4
Agriculture	8	13	14	16	13
Commerce	29	26	23	23	21
Transportation	1	3	3	4	4
Services	8	10	8	13	17
Other	19	17	22	9	8

Source: Bank of Lao P.D.R., External Audit Reports.

1/ Profit before tax divided by total balance sheet assets.

Table 7. Lao P.D.R.: Risk Assessment Matrix (RAM) 1/

Likelihood	Shock	Vulnerabilities	Potential Impact
Medium	Domestic systemic banking crisis	The financial sector has grown rapidly in recent years. Also, credit growth has been high, raising concerns over NPLs	High: Growth would slow down; there could be contingent liabilities for the government. The government has resorted to recapitalizing SOCBs in the past when capitalization fell below minimum statutory requirements.
Medium	Lack of restraint on off-budget spending	This could give rise to the BOL's quasi-fiscal lending operations and result in an increase in credit to the economy and, thus, inflation if the impact is not accompanied by sales of BOL securities.	Medium: Inflation would rise.
Medium	Strong intensification of the Euro Area crisis	Exports, FDI, and remittances would be affected.	Medium: Growth would slow down, especially in the nonresource sector.
Medium	Terms of trade shock	This could lead to a balance of payments crisis, currency substitution, and require intervention.	Medium: Balance of payments; foreign exchange reserves; dollarization; growth.

1/ Assumes no policy response to external shocks. The RAM shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of the staff).

LAO PEOPLE'S DEMOCRATIC REPUBLIC

August 16, 2012

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITYANALYSIS[1]

Approved By
David Cowen and Masato Miyazaki (IMF)
Andrew D. Mason and Jeffrey D. Lewis (IDA)

Prepared By
International Monetary Fund
International Development Association

Following the improvement in the country's CPIA rating, Lao P.D.R.'s risk of debt distress is reclassified from high to moderate, as all external debt distress indicators stay below policy-dependent indicative thresholds during the forecasting period under baseline assumptions, although thresholds are breached in the presence of certain shocks.[2] In addition, debt service ratios remain comfortably within the policy-dependent indicative thresholds even under stress conditions, due to the high level of concessionality of official borrowing. The new risk classification will have important implications for Lao P.D.R.'s borrowing capacity. While the composition of concessional funds is expected to be skewed away from grants and towards loans, the overall envelope of external resources available to the country should increase.

---

[1] This DSA was prepared jointly by the IMF and World Bank (WB), in consultation with the Asian Development Bank (AsDB). The debt data underlying this exercise were provided by the Lao P.D.R. authorities, the AsDB, and the WB, combined with IMF staff's estimates.

[2] The low-income country debt sustainability framework (LIC DSF) recognizes that better policies and institutions allow countries to manage higher levels of debt, and thus the threshold levels for debt indicators are policy-dependent. In the LIC-DSF, the quality of a country's policies and institutions is measured by the World Bank's Country Policy and Institutional Assessment (CPIA) index and classified into three categories: strong, medium, and weak. Lao P.D.R.'s policies and institutions, as measured by the CPIA, averaged 3.29 over the past 3 years. Since its average CPIA has been above the 3.25 mark for two years in a row, Lao P.D.R.'s policy performance has been reclassified from weak to medium according to the "Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-income Countries (www.imf.org/external/np/pp/eng/2010/012210.pdf)." Therefore, the relevant indicative thresholds for this category are: 40 percent for the PV of debt-to-GDP ratio, 150 percent for the PV of debt-to-exports ratio, 250 percent for the PV of debt-to-revenue ratio, 20 percent for the debt service-to-exports ratio, and 20 percent for the debt service-to-revenue ratio. These thresholds are applicable to public and publicly guaranteed external debt.

INTRODUCTION

1. **This LIC DSA for Lao P.D.R. reclassifies the risk of debt distress from high to moderate.**[3] Recent improvements in Lao P.D.R.'s CPIA index led to a reclassification of its policy performance from weak to moderate.[4] Consequently, Lao P.D.R.'s indicative debt distress thresholds were raised relative to 2011 levels. These higher thresholds combined with a similar debt dynamics relative to the previous DSA led to the risk reclassification.

Thresholds for External Debt
(In percent)

Indicator	Threshold Before	Threshold Now
Present value of debt to GDP	30	40
Present value of debt to exports	100	150
Present value of debt to revenue	200	250
Debt service to exports	15	20
Debt service to revenue 1/	25	20

Sources: Lao P.D.R. authorities; and IMF and World Bank staff estimates
1/ For debt service to revenue ratio, the applicable thresholds have been reduced.

2. **The high level of concessionality of official borrowing keeps debt service ratios at manageable levels.** In addition, public and publicly-guaranteed (PPG) external debt stock indicators are expected to remain below policy-dependent indicative thresholds throughout the entire projection period under the baseline. However, shocks to the domestic and external environment or excessively loose macroeconomic policies may push the stock of external public debt beyond sustainable levels, with some debt distress indicators breaching their respective thresholds under certain stress tests.[5] In this regard, debt dynamics are most sensitive to large real depreciations of the kip, as external debt is predominantly denominated in foreign currency.

BACKGROUND AND ASSUMPTIONS

3. **Lao P.D.R.'s external PPG debt remains elevated compared to other LICs in Asia, but its burden has eased considerably in the recent past.** The nominal stock of PPG debt increased from US$3.5 billion in 2010 to US$3.7 billion in 2011. However, high real GDP growth and the Kip's appreciation vis-à-vis the U.S. dollar contributed to a decline in the debt-to-GDP ratio from 50.3 percent of GDP to 44.4 percent of GDP in 2011. The corresponding net present value (PV) of debt at end-2011 was 29.8 percent of GDP, down from 36.6 percent of GDP in 2010. Similarly, the PV of PPG debt relative to exports declined from 85.9 percent in 2010 to 78.1 percent in 2011.

4. **Approximately 56 percent of PPG debt in Lao P.D.R. is held by multilateral creditors,** mainly the Asian Development Bank (AsDB—

[3] See the joint IMF-WB DSA for 2011: IMF Country Report No.12/165.

[4] Lao P.D.R.'s CPIA index was raised from 3.28 in 2010 to 3.4 in 2011.

[5] Stress tests include sharp exchange rate depreciation, more adverse terms of additional foreign financing, and reductions in GDP growth among others shocks.

33 percent) and the International Development Association (IDA—18 percent). Around 38 percent of the debt is held by bilateral creditors—mainly China, India, Japan, Korea, Russia, and Thailand. Noteworthy, the importance of bilateral creditors has increased vis-à-vis multilateral ones. Albeit small, the share of nonconcessional PPG debt has increased steadily in the last several years, standing at 6.3 percent in 2011. This increase was expected given heavy investments in hydropower and electricity generation projects, including the need by the public sector to finance equity stakes.

Lao P.D.R.: Stock of Public and Publicly Guaranteed External Debt at End-2011

	In Billions of U.S. Dollar	As a Share of Total External Debt	In percent of GDP
Total	3.7	100	44.4
Multilateral	2.1	55.8	24.7
Bilateral	1.4	37.9	16.9
Commercial 1/	0.2	6.3	2.8

Sources: Lao P.D.R. authorities; and IMF and World Bank staff estimates
1/ Includes direct borrowing by state-owned enterprises on nonconcessional terms.

5. The increasing presence of bilateral creditors underscores the need to strengthen debt management capacity. This is particularly important to ensure that debt sustainability considerations are taken into account when new debt is contracted. A mitigating factor for Lao P.D.R.'s external debt burden lies in the prospective returns on the hydropower and mining projects that have been financed in part by external PPG debt. While many of these projects face construction and implementation challenges, the long-term power purchase agreements that are signed for these projects and the resulting government revenues in the form of royalties, dividends, and profit tax payments arguably reduce the risk of debt distress.

6. Recorded domestic public debt rose to 8.9 percent of GDP in 2011, up from 8.5 percent of GDP in 2010, as the central bank disbursed more loans to finance local government's off-budget infrastructure projects. Lending from the Bank of Lao P.D.R. (BoL) to local governments represents about three-quarters of the recorded total domestic debt, with the remainder inclusive of government bonds related to the recapitalization of state-owned commercial banks (SOCBs). Total PPG domestic and external debt stood at 53.2 percent of GDP in 2011, down from 58.8 percent the year before. This improvement is also driven chiefly by the combination of GDP growth and exchange rate effects. The stock of BoL's loans to local governments is projected to peak in the near future as the BoL's quasi-fiscal operations are gradually phased out.

Lao P.D.R.: External Public Debt Indicators at End-2011

	Indicative thresholds	End-2011
Present value of debt, as a percent of:		
GDP	40	29.8
Exports	150	78.1
Revenue	250	182.9
Debt service, as a percent of:		
Exports	20	3.2
Revenue	20	7.5

Sources: Lao P.D.R. authorities; and IMF and World Bank staff estimates

ASSUMPTIONS UNDERLYING THE DEBT SUSTAINABILITY ANALYSIS

7. Box 1 summarizes the medium-term macroeconomic framework underlying the DSA. The baseline scenario—which is based on current policies—projects annual average growth of 7.9 percent between 2012 and 2017, in line with the authorities' targets. Growth would be supported by the strong performance of exports, especially from the resource sector, as well as by buoyant domestic activity, in particular agriculture, manufacturing, and services. Improvements to the business climate and the continued transition towards a market-based economy will also contribute to steady and more broad-based growth in Lao P.D.R.

Lao P.D.R. Macroeconomic Assumptions: Comparison with 2011
(Average over the 20 year projection horizon)

	2011 DSA	2012 DSA
GDP growth	6.7	6.8
GDP deflator in U.S. dollar terms (in percent)	3.3	2.1
Noninterest current account deficit	11.4	11.8
Primary deficit	0.3	0.7

Sources: Lao P.D.R. authorities; and IMF and World Bank staff estimates

8. **External financing is assumed to remain largely on concessional terms over the medium term.** As Lao P.D.R. graduates from its low-income country status over the longer term, grant financing is expected to decline relative to loans from bilateral creditors as well as from commercial sources.

DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

9. **Contrary to the previous DSAs, the PV of debt-to-GDP ratio is not expected to cross the policy-dependent indicative thresholds at any point during the forecasting period under baseline conditions** (Figure 1 and Table 1). This marked improvement is driven by the increase in the indicative threshold, as Lao P.D.R.'s policy performance was raised from weak to moderate due to its improved CPIA index of 3.4 in 2011. Similarly to last year's DSA, all three external debt stock indicators are projected to remain basically flat until about 2018, as large projected disbursements are expected to be counteracted by a combination of debt repayment and high GDP growth during the next several years. Also in line with the previous DSA, debt service ratios fall comfortably below policy-dependent thresholds during the entire forecasting period.

10. **Exchange rate and shocks to the cost of new loans present the most important risks to external debt sustainability.** Table 3 and Figure 1 illustrate how a one-off 30 percent depreciation of the kip vis-à-vis the U.S. dollar would lead to a sharp rise in the PV of the debt-to-GDP and the PV of debt-to-revenues, although in the last case the new policy-dependent threshold is not breached. A rise in the cost of additional financing (by 200 basis points relative to the baseline) would increase the PV of debt-to-exports ratio by more than 30 percentage points in the long run relative to the baseline. However, even under this extreme scenario, there would be no breaches of the corresponding threshold, contrary to the results in the previous DSA when policy performance was still rated as weak. Hence, improved policy performance reduced the vulnerability of Lao P.D.R.'s external debt to potential shocks to the cost of public funds.

11. **Debt dynamics continue to be markedly worse under an alternative scenario in which key variables are at their historical averages.** Through 2015, debt dynamics are more favorable under this historical scenario—which takes into account the appreciation of the kip relative to the U.S. dollar experienced during 2002–2011.[6] In later years, this effect is

[6] The kip appreciated 3 percent per year on average during this period.

Box 1. Baseline Scenario—Underlying Assumptions (2012–32)

The baseline macroeconomic framework assumes that the economy will be underpinned by further development of Lao P.D.R.'s potential in hydropower and mining, supported by continued reforms aimed at transitioning to a market economy and the strengthening of macroeconomic policies.

Real GDP growth is projected to average 7.9 percent between 2012–17. The near-term outlook is boosted by expanding production of mining and hydropower, with the (US$3.7 billion) Hongsa Lignite mining and power station expected to start operations in 2015–16. In addition, the outlook for tourism and agriculture is favorable, buoyed by domestic demand and strong FDI inflows. Over the longer term, assumed structural reforms would create a better environment for private investment, broadening the sources of growth. Real GDP is expected to moderate to 6.5 percent on average during 2018–32, as production in the resource sector reaches maturity. Over time, the share of agriculture in GDP is expected to decline, as the transition to a market based economy is accompanied by the rising importance of the industry and services sectors. Graduation from low-income status could be achieved in the second half of the projection period.

Inflation is projected to average 5.1 percent in 2012, down from 7.6 percent in 2011, on the back of lower food and fuel price inflation. Over the medium term, inflation is expected to decline further, but it is projected to remain above 4 percent until 2017.

The balance of payments continues to be driven by developments in the resource sector, which has an important bearing both in the current account and the capital and financial account. Starting from a large deficit of 21.4 percent of GDP in 2011, the current account is projected to improve considerably in the long-term. While the nonresource current account deficit is projected to deteriorate until 2018, the resource current account is forecasted to move into surplus as early as 2016, building on the maturation of mining and hydropower projects. In this context, the assumed pick up in nonresource exports and services is driven by strengthened competitiveness and regional integration, supported by improvements in the investment climate, streamlining of business regulations, and the prevalence of trade commitments. The overall external position is expected to strengthen over time, exemplified by the gradual improvement in the international reserves position. Private capital inflows in the form of FDI are expected to remain high through the first half of the projection period as large new projects get under way before they gradually decline to a more sustainable level.

External financing is assumed to remain on largely concessional terms over the medium term. In the long-run, however, grant financing decreases with economic development.

- **Multilateral creditors:** Projected loan disbursements in the medium term are relatively low, since IDA and AsDB have a pipeline of operations financed on grant terms. Over the longer term, grant financing decreases with economic development and project loans are assumed to increase moderately.
- **Bilateral creditors:** For 2012–13, project loan disbursements also increase, as donors provide support to the government's development agenda. Over the medium and longer term, greater participation by new emerging market creditors results in an increased role for bilateral finance, including for lending purposes to state-owned enterprises.
- **Commercial creditors:** Over the medium term, commercial disbursements are relatively small, principally used to finance a portion of the government's equity stake participation in the new hydropower projects. The DSA assumes that disbursements of the government's borrowing to finance its equity stake in the Hongsa Lignite project will take place in 2014 and 2015.

Fiscal policy is projected to remain on a consolidation path, with the primary deficit declining from 2.4 percent of GDP in 2011 to 1.3 percent of GDP in 2018, before reaching 0.5 percent of GDP towards the end of the projection period. Reductions in the deficit are largely driven by expected declines in primary expenditures, since the ratio of revenues and grants to GDP are forecasted to decline from their 2012 peak starting in 2013.

Domestic debt decreases over the medium term driven by repayments of the lending to local governments from the BoL. In the long term, net external finance declines relative to GDP, and a larger share of budget deficits is financed domestically, pushing domestic debt to higher but sustainable levels.

outweighed by the higher historical average of the current account deficit (14.7 percent of GDP per annum compared to 10.0 percent of GDP per annum in the baseline), and the lower historical average for FDI (4.6 percent of GDP per annum compared to 9.0 percent of GDP per annum in the baseline). These estimates indicate that the historical scenario assumes around 9 percentage points of GDP more in debt accumulation the baseline, putting Lao P.D.R. on an unsustainable path in the long run. Therefore, a negative shock to FDI in Lao P.D.R. would force it to reduce substantially its current account deficit in order to avoid external debt distress.

B. Public Sector Debt Sustainability

12. In line with the previous DSA's projections, the PV of total PPG debt in percent of GDP and in percent of revenue are both projected to decline markedly over the long run under baseline assumptions (Figure 2 and Table 2). Domestic debt is expected to decline from 8.9 percent of GDP in 2011 to about 5.4 percent of GDP by 2017. In addition, the PV of debt-to-revenue ratio is also projected to decline during the forecasting period.

13. Public debt ratios are particularly sensitive to a kip depreciation over the medium term (Figure 2 and Table 4). Similarly to the results in the last DSA, a 30 percent real depreciation of the kip would immediately raise the PV of public debt-to-GDP and the PV of public debt-to-revenue, before both indicators start a declining trend once again. While the debt service-to-revenue ratio is relatively stable under the baseline scenario, it would increase permanently by a substantial margin if the kip were to depreciate sharply. It should be noted that this scenario is likely to overstate risks given that a significant share of GDP, including most of the resource GDP, is earned in foreign currency

14. Public debt indicators are susceptible to the effects of contingent liabilities. The settlement of arrears and debts to contractors, related to public investment projects implemented by local governments and the recapitalization of SOCBs could lead to a rise in recorded domestic public debt. As an illustration, the fifth bound test, which considers the effect of a 10 percent of GDP increase in other debt-creating flows, provides hints on the possible effect of a resolution of relevant contingent public liabilities.

15. Alternative scenarios show less positive debt dynamics over the longer term. For example, in a historical scenario where real GDP growth and the primary balance are fixed at their historical averages, the PV of public debt-to-GDP ratio rises above 42 percent by 2032. If, however, the primary balance were fixed at the level projected for 2012, the PV of debt-to-GDP would be roughly unchanged in the medium term, but it would be higher relative to baseline conditions by the end of the projection period. Together, these results highlight the importance of efforts towards improving fiscal balances over time, even relative to the positive fiscal performance expected for this year.

16. The baseline scenario also assumes that the BoL will slow down its quasi-fiscal operations. Naturally, public debt dynamics could deteriorate significantly should this assumption not materialize.

THE AUTHORITIES' VIEWS

17. Authorities broadly agreed with the overall assessment and indicated they are supportive of the reclassification of debt distress. They expect to capitalize on the better risk classification to expand access to official resources and improve their ability to finance capital needs. In addition, the authorities agreed with staff that a better risk classification may improve access to nonconcessional loans in the future. This is important since Lao P.D.R. is expected to rely more on commercial funds as it graduates from its low-income country status over the medium term.

18. The authorities highlighted that debt projections over the medium term remained imprecise and questioned the exchange rate assumptions built into the framework. On the basis of information provided by local contracting parties, the authorities anticipated a smaller increase in disbursements of new funds from some bilateral donors between 2012 and 2017 than assumed in the DSA.[7] In addition, they questioned staff's projections for the evolution of the kip-U.S. dollar exchange rate—driven by inflation differentials—which has an important bearing on external debt indicators.

CONCLUSION

19. Due to recent improvements in policy performance, Lao P.D.R.'s risk of debt distress has been reclassified from high to moderate. The improved 2011 CPIA index moved Lao P.D.R. to the group of countries with medium rather than weak policy performance, raising its policy-dependent debt distress thresholds. Consequently, the new marks are not breached by any of the debt distress indicators under baseline conditions. Since debt dynamics are relatively similar to what was projected in the previous DSA, it is clear that the risk reclassification is driven by improvements in domestic policies and institutions.

20. These gains notwithstanding, results are still sensitive to assumptions regarding investment and performance of the resource sector. Despite long-term contracts with fixed prices for energy exports to neighboring countries, Lao P.D.R.'s economy remains exposed to fluctuations in copper and gold prices in the medium term, as well as to economic developments in its main trading partners (China, Thailand and Vietnam).[8] Lower growth in Lao P.D.R. and a weaker balance of payments would worsen debt dynamics. Thus, a tightening of macroeconomic policies can support external sustainability. Cautious assessment and monitoring of large-scale projects and private external debt will be required to mitigate the risks posed to external and public debt sustainability,

---

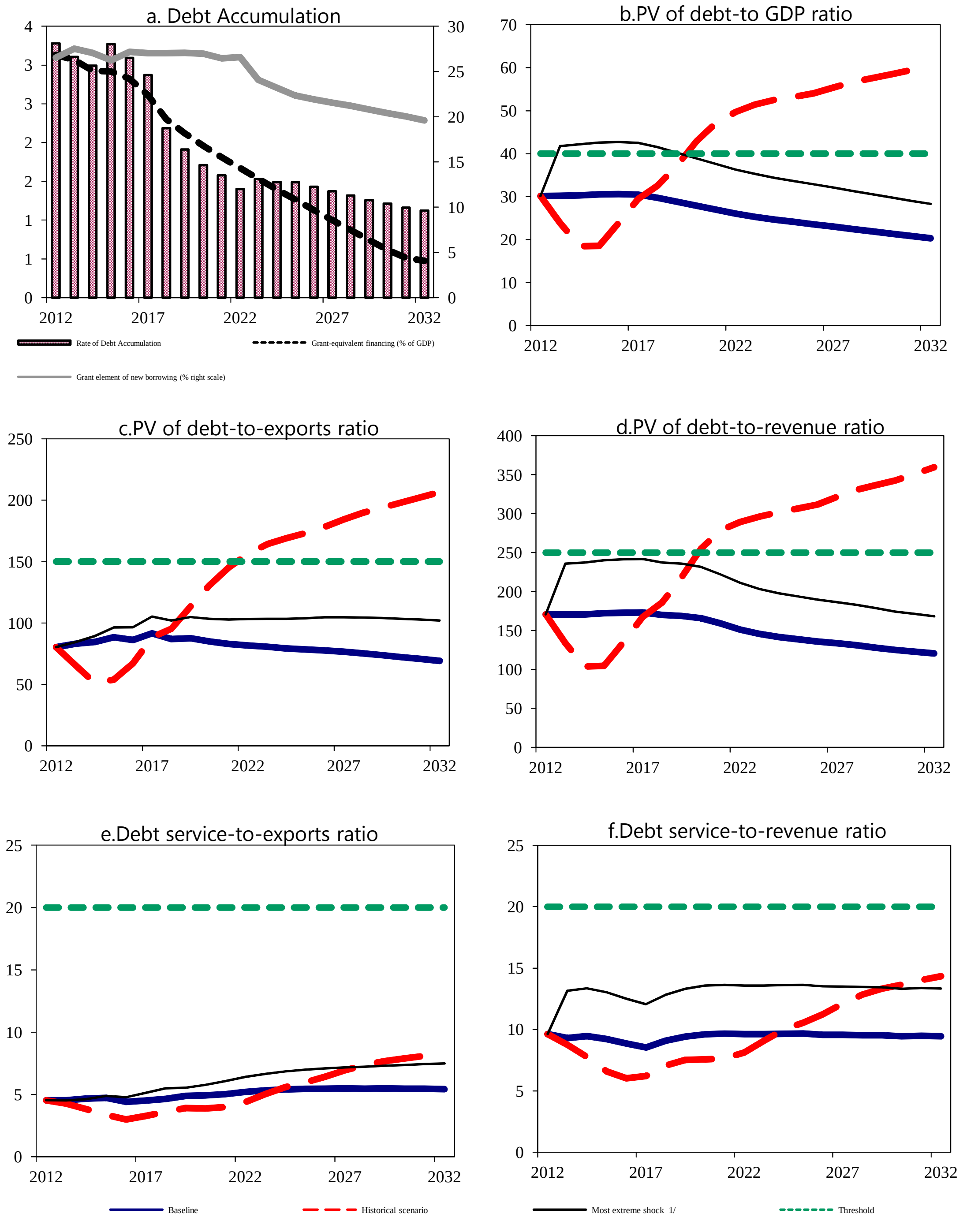
[7] The staff maintained the US$600 million of projected disbursements from China between 2012–2017, which is based on information collected by previous missions. These disbursements do not, however, result in a material change in the overall assessment of debt distress.

[8] In a customized scenario where commodity prices decline by 20 percent in 2013 and 2014, debt stock indicators approach or even reach their policy-dependent thresholds, illustrating the vulnerability of Lao P.D.R. to commodity price shocks. However, this customized scenario poses less of a threat to debt dynamics than the historical scenario.

especially if some of these projects are financed from commercial sources, such as bonds backed by future revenues.

21. External borrowing should mostly be obtained on concessional terms and fiscal and quasi-fiscal liabilities should be carefully managed, to further create buffers against vulnerabilities. Improving debt management capacity and developing a medium-term borrowing strategy for the government could also lead to more efficient utilization of borrowed funds and more favorable debt dynamics even under stress scenarios. If these conditions were to materialize, Lao P.D.R.'s risk of debt distress could improve even further.

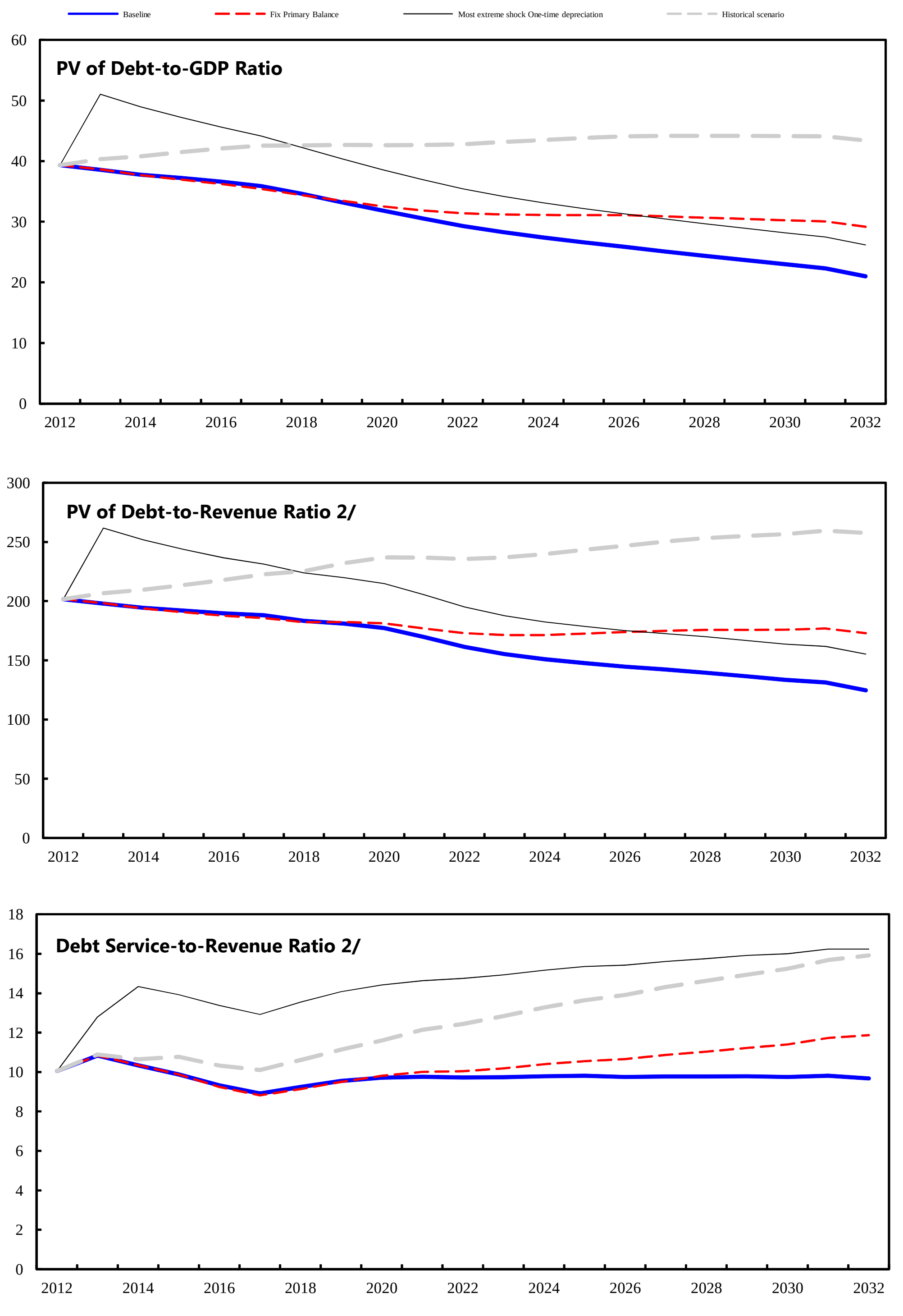
Figure 1. Lao P.D.R.: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2012–2032 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2022. In figure b. it corresponds to a One-time depreciation shock; in c. to a Terms shock; in d. to a One-time depreciation shock; in e. to a Terms shock and in figure f. to a One-time depreciation shock

Figure 2. Lao P.D.R.: Indicators of Public Debt Under Alternative Scenarios, 2012–2032 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2022.
2/ Revenues are defined inclusive of grants.

Table 1. Lao P.D.R.: External Debt Sustainability Framework, Baseline Scenario, 2009–2032 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 1/	Standard Deviation 1/	Projections									
	2009	2010	2011			2012	2013	2014	2015	2016	2017	2012–2017 Average	2022	2032	2018–2032 Average
External debt (nominal) 2/	**102.4**	**88.1**	**82.9**			**87.5**	**94.2**	**102.0**	**102.3**	**97.8**	**92.7**		**66.6**	**53.7**	
o/w public and publicly guaranteed (PPG)	56.0	50.3	44.3			44.1	43.7	43.4	43.3	43.0	42.4		35.1	26.0	
Change in external debt	5.0	-14.3	-5.2			4.6	6.6	7.8	0.3	-4.5	-5.1		-4.0	-1.5	
Identified net debt-creating flows	8.0	-10.4	-1.0			9.6	11.2	11.8	4.7	-2.1	-3.5		-2.8	-2.3	
Non-interest current account deficit	**19.7**	**16.4**	**20.0**	**14.7**	**4.2**	**20.3**	**22.6**	**22.7**	**20.5**	**13.6**	**13.0**		**10.7**	**6.0**	9.5
Deficit in balance of goods and services	18.6	14.7	19.7			21.0	24.0	24.2	21.7	15.5	14.9		12.0	7.7	
Exports	34.3	40.0	38.2			37.5	36.4	35.8	34.5	35.5	33.3		31.8	29.3	
Imports	52.9	54.7	57.8			58.5	60.4	60.0	56.2	51.0	48.2		43.8	37.0	
Net current transfers (negative = inflow)	-2.4	-2.6	-2.6	-2.8	0.6	-2.6	-2.6	-2.6	-2.6	-2.6	-2.5		-2.0	-2.0	-2.0
o/w official	-1.7	-1.6	-1.6			-1.6	-1.6	-1.6	-1.6	-1.6	-1.5		-1.0	0.0	
Other current account flows (negative = net inflow)	3.5	4.3	2.9			1.9	1.2	1.1	1.4	0.7	0.6		0.7	0.4	
Net FDI (negative = inflow)	**-7.6**	**-9.9**	**-7.0**	**-4.6**	**3.5**	**-6.1**	**-6.5**	**-5.4**	**-9.7**	**-11.0**	**-11.8**		**-10.5**	**-6.0**	-8.7
Endogenous debt dynamics 3/	**-4.1**	**-16.9**	**-14.0**			**-4.6**	**-5.0**	**-5.4**	**-6.1**	**-4.7**	**-4.7**		**-3.1**	**-2.4**	
Contribution from nominal interest rate	1.2	1.9	1.3			1.5	1.4	1.3	1.1	2.6	2.3		1.2	0.6	
Contribution from real GDP growth	-6.9	-6.8	-5.8			-6.2	-6.4	-6.7	-7.2	-7.4	-6.9		-4.3	-3.0	
Contribution from price and exchange rate changes	1.6	-12.0	-9.5			...	...	...	...	...	...		...	...	
Residual (3-4) 4/	**-3.1**	**-4.0**	**-4.2**			**-5.0**	**-4.5**	**-4.0**	**-4.4**	**-2.4**	**-1.6**		**-1.1**	**0.8**	
o/w exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 5/	...	...	68.4			73.5	80.6	88.8	89.5	85.4	80.8		57.5	48.0	
In percent of exports	...	...	179.1			196.2	221.8	247.9	259.3	240.4	242.8		180.8	163.9	
PV of PPG external debt	**...**	**...**	**29.8**			**30.1**	**30.2**	**30.3**	**30.5**	**30.6**	**30.5**		**26.0**	**20.3**	
In percent of exports	**...**	**...**	**78.1**			**80.4**	**83.1**	**84.5**	**88.5**	**86.1**	**91.6**		**81.9**	**69.3**	
In percent of government revenues	**...**	**...**	**182.9**			**170.7**	**170.6**	**170.7**	**172.3**	**173.0**	**173.4**		**151.4**	**120.6**	
Debt service-to-exports ratio (in percent)	**89.8**	**80.9**	**63.2**			**60.5**	**78.5**	**76.0**	**69.1**	**119.6**	**133.1**		**102.9**	**53.0**	
PPG debt service-to-exports ratio (in percent)	**4.9**	**4.3**	**3.2**			**4.5**	**4.5**	**4.7**	**4.7**	**4.4**	**4.5**		**5.2**	**5.4**	
PPG debt service-to-revenue ratio (in percent)	**10.8**	**11.0**	**7.5**			**9.6**	**9.3**	**9.5**	**9.2**	**8.8**	**8.5**		**9.6**	**9.4**	
Total gross financing need (Billions of U.S. dollars)	2.4	2.7	3.1			3.4	4.6	5.0	4.3	6.1	6.8		7.7	8.2	
Non-interest current account deficit that stabilizes debt ratio	14.7	30.8	25.2			15.7	16.0	14.8	20.2	18.1	18.1		14.7	7.5	
Key macroeconomic assumptions															
Real GDP growth (in percent)	7.5	8.1	8.0	7.5	0.7	8.3	8.0	7.7	7.8	7.9	7.8	7.9	6.7	5.9	6.5
GDP deflator in US dollar terms (change in percent)	-1.6	13.3	12.1	9.4	7.0	3.1	2.6	1.3	1.9	1.8	2.0	2.1	2.2	2.2	2.2
Effective interest rate (percent) 6/	1.3	2.3	1.8	1.8	0.3	2.0	1.7	1.5	1.2	2.8	2.5	2.0	1.9	1.2	1.7
Growth of exports of G&S (US dollar terms, in percent)	-5.2	42.8	15.7	20.0	17.5	9.6	7.5	7.6	5.8	13.1	3.0	7.8	6.7	7.8	7.9
Growth of imports of G&S (US dollar terms, in percent)	1.4	26.7	28.1	20.8	12.7	12.9	14.3	8.4	3.0	-0.3	3.8	7.0	9.9	6.4	7.0
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	26.5	27.5	27.1	26.2	27.2	27.0	26.9	26.6	19.6	23.3
Government revenues (excluding grants, in percent of GDP)	15.6	15.8	16.3			17.7	17.7	17.8	17.7	17.7	17.6		17.2	16.8	17.2
Aid flows (in Billions of US dollars) 7/	0.1	0.2	0.2			0.3	0.3	0.3	0.3	0.3	0.3		0.4	0.2	
o/w Grants	0.1	0.2	0.2			0.2	0.2	0.2	0.2	0.2	0.2		0.2	0.0	
o/w Concessional loans	0.0	0.0	0.0			0.1	0.1	0.1	0.1	0.1	0.1		0.1	0.2	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			3.1	3.1	2.9	2.9	2.8	2.6		1.7	0.5	1.3
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			47.0	47.6	46.7	45.3	46.3	46.5		46.1	20.3	36.4
Memorandum items:															
Nominal GDP (Billions of US dollars)	5.6	6.9	8.3			9.3	10.3	11.2	12.3	13.5	14.9		23.4	52.7	
Nominal dollar GDP growth	5.7	22.5	21.1			11.6	10.8	9.1	9.9	9.9	9.9	10.2	9.0	8.2	8.8
PV of PPG external debt (in Billions of US dollars)			2.5			2.7	3.0	3.3	3.7	4.1	4.5		6.0	10.6	
(PVt-PVt-1)/GDPt-1 (in percent)						3.3	3.1	3.0	3.3	3.1	2.9	3.1	1.4	1.1	1.5
Gross workers' remittances (Billions of US dollars)	0.0	0.1	0.1			0.1	0.1	0.1	0.1	0.1	0.1		0.3	1.1	
PV of PPG external debt (in percent of GDP + remittances)	...	...	29.5			29.8	29.9	30.0	30.2	30.3	30.2		25.7	19.9	
PV of PPG external debt (in percent of exports + remittances)	...	...	76.1			78.4	80.9	82.2	86.0	83.8	88.9		79.2	64.8	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	3.1			4.4	4.4	4.6	4.6	4.3	4.4		5.0	5.1	

Sources: Country authorities; and staff estimates and projections.
1/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.
2/ Includes both public and private sector external debt.
3/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.
4/ Includes exceptional financing (i.e., changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
5/ Assumes that PV of private sector debt is equivalent to its face value.
6/ Current-year interest payments divided by previous period debt stock.
7/ Defined as grants, concessional loans, and debt relief.
8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 2. Lao P.D.R.: Public Sector Debt Sustainability Framework, Baseline Scenario, 2009–2032

(In percent of GDP, unless otherwise indicated)

	Actual					Projections									
	2009	2010	2011	Average 1/	Standard Deviation	2012	2013	2014	2015	2016	2017	2012–17 Average	2022	2032	2018–32 Average
Public sector debt 2/	63.1	58.8	53.2			53.4	52.1	50.9	50.0	49.0	47.8		38.4	26.7	
o/w foreign-currency denominated	56.0	50.3	44.3			44.1	43.7	43.4	43.3	43.0	42.4		35.1	26.0	
Change in public sector debt	4.9	-4.2	-5.6			0.2	-1.2	-1.2	-0.9	-1.0	-1.2		-1.8	-1.5	
Identified debt-creating flows	4.9	-8.0	-6.2			-2.7	-3.0	-2.3	-2.3	-2.3	-2.2		-2.4	-1.3	
Primary deficit	6.1	3.7	2.4	3.3	1.2	1.4	1.3	1.6	1.6	1.5	1.5	1.5	0.3	0.4	0.4
Revenue and grants	17.9	18.1	18.4			19.5	19.5	19.4	19.4	19.3	19.1		18.2	16.9	
of which: grants	2.3	2.3	2.1			1.9	1.8	1.7	1.7	1.6	1.5		1.0	0.0	
Primary (noninterest) expenditure	24.1	21.8	20.8			20.9	20.8	21.1	21.0	20.8	20.5		18.4	17.2	
Automatic debt dynamics	-1.0	-11.7	-8.6			-4.1	-4.2	-3.9	-3.9	-3.8	-3.7		-2.7	-1.6	
Contribution from interest rate/growth differential	-3.8	-5.0	-5.3			-4.1	-3.9	-3.7	-3.7	-3.7	-3.6		-2.5	-1.5	
of which: contribution from average real interest rate	0.3	-0.3	-0.9			0.0	0.1	0.1	0.0	0.0	0.0		0.0	0.1	
of which: contribution from real GDP growth	-4.1	-4.7	-4.4			-4.1	-4.0	-3.7	-3.7	-3.7	-3.5		-2.5	-1.6	
Contribution from real exchange rate depreciation	2.8	-6.7	-3.3			0.0	-0.3	-0.2	-0.2	-0.1	-0.1		...	...	
Other identified debt-creating flows	-0.3	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	-0.3	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	-0.1	3.8	0.6			2.9	1.7	1.1	1.4	1.3	1.1		0.7	-0.3	
Other Sustainability Indicators															
PV of public sector debt	...	...	38.7			39.3	38.6	37.8	37.2	36.6	35.9		29.3	21.0	
o/w foreign-currency denominated	...	...	29.8			30.1	30.2	30.3	30.5	30.6	30.5		26.0	20.3	
o/w external	...	...	29.8			30.1	30.2	30.3	30.5	30.6	30.5		26.0	20.3	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 3/	9.2	6.6	4.8			4.5	4.8	5.7	5.4	5.1	4.8		3.1	2.6	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	210.5			201.6	197.9	194.3	192.0	189.8	188.1		161.4	124.7	
PV of public sector debt-to-revenue ratio (in percent)	...	...	237.4			222.8	217.8	212.8	210.1	206.9	204.1		170.4	124.8	
o/w external 4/	...	...	182.9			170.7	170.6	170.7	172.3	173.0	173.4		151.4	120.6	
Debt service-to-revenue and grants ratio (in percent) 5/	10.2	10.3	7.2			10.1	10.8	10.3	9.9	9.3	8.9		9.7	9.7	
Debt service-to-revenue ratio (in percent) 5/	11.7	11.8	8.1			11.1	11.9	11.3	10.8	10.2	9.7		10.3	9.7	
Primary deficit that stabilizes the debt-to-GDP ratio	1.3	7.9	8.1			1.2	2.5	2.8	2.5	2.5	2.6		2.0	1.9	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	7.5	8.1	8.0	7.5	0.7	8.3	8.0	7.7	7.8	7.9	7.8	7.9	6.7	5.9	6.5
Average nominal interest rate on forex debt (in percent)	0.9	1.4	0.7	0.9	0.3	1.5	1.5	1.7	1.7	1.7	1.7	1.6	1.7	2.1	1.8
Average real interest rate on domestic debt (in percent)	8.5	-7.0	-6.8	2.1	10.0	-1.2	-0.6	-0.5	-0.6	-0.5	-0.7	-0.7	-0.9	-1.3	-0.8
Real exchange rate depreciation (in percent, + indicates depreciation)	5.6	-12.9	-7.2	-6.7	7.7	-0.1	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	-4.3	10.0	8.9	8.2	5.4	4.7	6.5	5.0	4.9	4.4	4.4	5.0	4.4	4.4	4.4
Growth of real primary spending (deflated by GDP deflator, in percent)	0.3	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grant element of new external borrowing (in percent)	...	...	...	...	...	26.5	27.5	27.1	26.2	27.2	27.0	26.9	26.6	19.6	...

Sources: Country authorities; and staff estimates and projections.
1/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.
2/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]
3/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
4/ Revenues excluding grants.
5/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

Table 3. Lao P.D.R.: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2012–2032

(In percent)

	Projections							
	2012	2013	2014	2015	2016	2017	**2022**	2032
PV of debt-to GDP ratio								
Baseline	30	30	30	31	31	30	**26**	20
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2012–2032 1/	30	24	18	19	24	29	**50**	61
A2. New public sector loans on less favorable terms in 2012–2032 2/	30	31	32	33	34	35	**33**	30
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2013–2014	30	30	30	31	31	31	**26**	20
B2. Export value growth at historical average minus one standard deviation in 2013–2014 3/	30	31	34	34	34	33	**28**	21
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013–2014	30	30	30	30	30	30	**25**	20
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013–2014 4/	30	34	38	37	37	37	**30**	21
B5. Combination of B1-B4 using one-half standard deviation shocks	30	31	29	30	30	29	**25**	19
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	30	42	42	43	43	43	**36**	28
PV of debt-to-exports ratio								
Baseline	80	83	85	88	86	92	**82**	69
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2012–2032 1/	80	66	51	54	67	88	**156**	207
A2. New public sector loans on less favorable terms in 2012–2032 2/	80	84	89	96	97	105	**103**	102
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2013–2014	80	81	83	87	85	90	**81**	68
B2. Export value growth at historical average minus one standard deviation in 2013–2014 3/	80	89	103	108	104	110	**96**	78
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013–2014	80	81	83	87	85	90	**81**	68
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013–2014 4/	80	93	105	108	104	110	**94**	72
B5. Combination of B1-B4 using one-half standard deviation shocks	80	83	82	85	83	88	**78**	65
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	80	81	83	87	85	90	**81**	68
PV of debt-to-revenue ratio								
Baseline	171	171	171	172	173	173	**151**	121
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2012–2032 1/	171	135	104	105	135	167	**289**	359
A2. New public sector loans on less favorable terms in 2012–2032 2/	171	173	180	188	194	199	**191**	178
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2013–2014	171	169	172	174	174	175	**153**	122
B2. Export value growth at historical average minus one standard deviation in 2013–2014 3/	171	174	189	190	190	189	**162**	122
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013–2014	171	167	166	168	169	169	**148**	118
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013–2014 4/	171	192	212	211	210	208	**174**	126
B5. Combination of B1-B4 using one-half standard deviation shocks	171	173	166	167	168	167	**145**	113
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	171	236	237	240	241	242	**211**	168

Table 3. Lao P.D.R.: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2012–2032 (concluded)

(In percent)

Debt service-to-exports ratio								
Baseline	5	5	5	5	4	5	**5**	5
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2012–2032 1/	5	4	4	3	3	3	**4**	8
A2. New public sector loans on less favorable terms in 2012–2032 2/	5	5	5	5	5	5	**6**	7
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2013–2014	5	5	5	5	4	5	**5**	5
B2. Export value growth at historical average minus one standard deviation in 2013–2014 3/	5	5	5	5	5	5	**6**	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013–2014	5	5	5	5	4	5	**5**	5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013–2014 4/	5	5	5	5	5	5	**6**	6
B5. Combination of B1-B4 using one-half standard deviation shocks	5	4	4	5	4	4	**5**	5
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	5	5	5	5	4	5	**5**	5
Debt service-to-revenue ratio								
Baseline	10	9	9	9	9	9	**10**	9
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2012–2032 1/	10	9	8	7	6	6	**8**	14
A2. New public sector loans on less favorable terms in 2012–2032 2/	10	9	9	10	10	10	**12**	13
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2013–2014	10	9	10	9	9	9	**10**	10
B2. Export value growth at historical average minus one standard deviation in 2013–2014 3/	10	9	10	10	9	9	**11**	10
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013–2014	10	9	9	9	9	8	**10**	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013–2014 4/	10	9	10	10	10	9	**12**	10
B5. Combination of B1-B4 using one-half standard deviation shocks	10	9	9	9	8	8	**9**	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	10	13	13	13	13	12	**14**	13
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	23	23	23	23	23	23	**23**	23

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 4. Lao P.D.R.: Sensitivity Analysis for Key Indicators of Public Debt 2012–2032

		Projections						
	2012	2013	2014	2015	2016	2017	2022	2032
PV of Debt-to-GDP Ratio								
Baseline	39	39	38	37	37	36	29	21
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	39	40	41	41	42	43	43	43
A2. Primary balance is unchanged from 2012	39	39	38	37	36	35	31	29
A3. Permanently lower GDP growth 1/	39	39	38	38	37	36	31	25
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2013–2014	39	39	39	39	38	38	32	25
B2. Primary balance is at historical average minus one standard deviations in 2013–2014	39	41	42	42	41	40	32	23
B3. Combination of B1–B2 using one half standard deviation shocks	39	41	42	41	41	40	33	25
B4. One-time 30 percent real depreciation in 2013	39	51	49	47	46	44	35	26
B5. 10 percent of GDP increase in other debt-creating flows in 2013	39	46	45	44	43	42	34	23
PV of Debt-to-Revenue Ratio 2/								
Baseline	202	198	194	192	190	188	161	125
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	202	207	210	214	218	223	236	258
A2. Primary balance is unchanged from 2012	202	198	194	191	188	186	173	173
A3. Permanently lower GDP growth 1/	202	198	195	193	192	191	169	147
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2013–2014	202	201	201	200	199	198	177	149
B2. Primary balance is at historical average minus one standard deviations in 2013–2014	202	211	218	214	211	208	177	134
B3. Combination of B1–B2 using one half standard deviation shocks	202	210	216	213	211	209	183	148
B4. One-time 30 percent real depreciation in 2013	202	262	252	244	237	231	195	155
B5. 10 percent of GDP increase in other debt-creating flows in 2013	202	237	232	227	223	219	186	139
Debt Service-to-Revenue Ratio 2/								
Baseline	10	11	10	10	9	9	10	10
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	10	11	11	11	10	10	12	16
A2. Primary balance is unchanged from 2012	10	11	10	10	9	9	10	12
A3. Permanently lower GDP growth 1/	10	11	10	10	9	9	10	11
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2013–2014	10	11	11	10	10	9	10	11
B2. Primary balance is at historical average minus one standard deviations in 2013–2014	10	11	11	11	11	9	11	10
B3. Combination of B1–B2 using one half standard deviation shocks	10	11	11	11	10	10	11	11
B4. One-time 30 percent real depreciation in 2013	10	13	14	14	13	13	15	16
B5. 10 percent of GDP increase in other debt-creating flows in 2013	10	11	11	13	10	10	12	11

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

August 16, 2012

Prepared By

Asia and Pacific Department
(In consultation with other Departments)

CONTENTS

ANNEX I. FUND RELATIONS

(As of July 31, 2012)

A. Membership Status

Joined: July 05, 1961; Article XIV

B. General Resources Account

	SDR Million	Percent of Quota
Quota	52.90	100.00
Fund holdings of currency	52.90	100.00
Reserve position in Fund	0.00	0.00

C. SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	50.68	100.00
Holdings	51.07	100.78

D. Outstanding Purchases and Loans

	SDR Million	Percent of Quota
ECF arrangements	1.81	3.43

E. Latest Financial Arrangements

In millions of SDRs (mm/dd/yyyy)

Type	Date of Arrangement	Expiration Date	Amount Approved	Amount Drawn
ECF[1]	04/25/2001	04/24/2005	31.70	18.12
ECF[1]	06/04/1993	05/07/1997	35.19	35.19
SAF	09/18/1989	09/17/1992	20.51	20.51

F. Projected Payments to Fund

In millions of SDRs (based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2012	2013	2014	2015	2016
Principal	0.91	0.91			
Charges/interest		0.00	0.00	0.00	0.00
Total	**0.91**	**0.91**	**0.00**	**0.00**	**0.00**

[1] Extended Credit Facility (ECF), formerly PRGF.

G. Exchange Arrangement

The exchange rate arrangement is classified as "stabilized." The de jure arrangement is floating. The authorities' objective is to limit currency fluctuations vis-à-vis major currencies, including the U.S. dollar and Thai baht within ±5 percent per annum. The Bank of the Lao P.D.R. (BoL) sets a daily official reference rate, which is calculated as a weighted average of the previous day's interbank rates. Commercial banks and foreign exchange bureaus are required to maintain their buying and selling rates within ±0.25 percent of the BoL's daily reference rate for the U.S. dollar. For the euro and baht, the buying and selling rates may not exceed a margin of 0.5 percent. For other currencies, a margin of 2 percent applies.

On May 28, 2010, Lao P.D.R. accepted the obligations under Article VIII, Section 2, 3, and 4, following the elimination of one restriction subject to Fund jurisdiction under Article VIII arising from a requirement to obtain tax payment certificates for some transactions. Lao P.D.R. now maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for restrictions imposed solely for the preservation of national or international security notified to the Fund pursuant to Decision No. 144-(52/51).

H. Article IV Consultations

The last Article IV consultation discussions were held in Vientiane during May 11–24, 2011 and were concluded by the Executive Board on

July 8, 2011. The staff report (Country Report No. 11/257) was published on August 2011.

I. Technical Assistance

Over the past three years, Lao P.D.R. has received technical assistance in the areas of customs and tax revenue administration; price statistics; and the national accounts. A new IMF office that will facilitate technical assistance to Lao P.D.R. as well as Myanmar was announced in July 2012. The office will be based at the Bank of Thailand.

J. Resident Representative

Mr. Sanjay Kalra assumed the Senior Resident Representative post for Vietnam and Lao P.D.R., based in Hanoi, on October 16, 2011.

ANNEX II. IMF-WORLD BANK COLLABORATION

The Bank and the IMF country teams for Lao P.D.R. met on July 3, 2012 to identify macro-critical structural reforms and to coordinate the two teams' work for FY13. The teams were led by Ms. Keiko Miwa (Country Manager, EASPR, World Bank), Mr. Sudhir Shetty (Director, EASPR, World Bank) and Mr. Dennis Botman (IMF Mission Chief for Lao P.D.R.).

The teams agreed that Lao P.D.R. had made impressive progress and that the key challenge going forward is to maintain macroeconomic and financial stability, achieve more diversified growth, and ensure that the country's natural resource wealth is developed in a sustainable way that benefits the entire population.

Prudent fiscal and monetary policies and a strengthening of policy frameworks, including financial sector supervision and regulation, are essential to preserve banking sector soundness and replenish international reserves. Reforms to public financial management will need to be strengthened further—on both the tax and spending side—along with improvements in the enabling environment for private sector development to help ensure that Lao P.D.R.'s resource wealth is not the only source of economic progress and that economic development results in a generalized improvement in living standards and reduction in poverty.

Lao P.D.R.: Bank and Fund Planned Activities in Macro-Critical Structural Reform Areas, June 2012–May 2013

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1.World Bank Program	New series of Poverty Reduction Support Operations (PRSOs)	Preparatory work and missions throughout fiscal year 2012–13 (identification mission tentatively scheduled in September 2011)	Board discussion expected in August 2012 and July 2013
	Customs and Trade Facilitation Project (CTFP) and Trade Development Facility (TDF)	Ongoing	Implementation throughout fiscal year TDF2 expected in December 2012
	New IDA and Multi-Donor Trust-Fund Project supporting the Government Public Financial Management Strengthening Program (PFMSP)	Ongoing	New IDA approval expected in February 2013
	Hydro-Mining Technical Assistance Project	Ongoing	Implementation throughout fiscal year 2013
	Lao Statistical Capacity Building Project (LAOSTAT)	Ongoing	Approval expected in November 2012
	Analytical work: macroeconomic monitoring (Lao economic monitors), investment climate, human resource development and skills reports	Ongoing	Reports available by May 2013
2. IMF Work Program	Periodic staff visits by IMF resident representative based in Hanoi	July 2012	July 2013.
	Article IV Consultation	July 2012	Board discussion including on the JSAN August 2012
	Article IV Consultation	July 2013	Board discussion on a Lapse of Time Basis
	TA on customs revenue administration and modernization	FY2012, peripatetic expert visit and/or an FAD mission	BTO/TA report in FY12
3. Joint Work Program	External Debt Sustainability Analysis	July 2012 July 2013	July 2012 July 2013

ANNEX III. RELATIONS WITH THE ASIAN DEVELOPMENT BANK

The Asian Development Bank's (AsDB) current Country Partnership Strategy (CPS) 2012–2016 is aligned with the government's development strategy (National Socio-Economic Development Plan (NSEDP, 7th Five-Year Plan)), and seeks to promote inclusive and sustainable economic growth and poverty reduction. The country assistance program evaluation, 2000–09, concluded that the AsDB's assistance was successful, relevant, and effective. The CPS is designed to help the government diversify the economy in a sustainable and inclusive manner through agriculture and natural resources, education, energy, urban development, and public sector management. The CPS aims to maximize efficiency and sustainability through larger operations implemented over a longer period; maximize synergies with Greater Mekong Subregion program; and increase responsiveness to emerging issues in a rapidly changing economy. It highlights four thematic areas that will influence the design and focus of activities, including private sector development, governance, gender equity, and regional cooperation and integration. The CPS focuses on four core sectors: education, agriculture and natural resources, water supply and other municipal infrastructure and services, and energy. Strengthening public sector management is a crosscutting issue, key to efficient and effective development in Lao P.D.R. The performance-based allocation of the Asian Development Fund (ADF), based on the country performance assessment (CPA) finalized in 2010, provided Lao P.D.R. with an ADF allocation in the amount of US$152 million for the biennial period 2011–12. The CPA for the next allocation period (2013–2014) will be finalized by the end of 2012.

As of end-2011, cumulative loans/grants approved stood at US$631.48 million, out of which a cumulative amount of US$266.66 million was awarded for contracts. During 2011, US$73.2 million of grants were disbursed and US$53.2 million of contracts were awarded. Seven new technical assistance (TA) projects for a total of US$7.6 million were approved in 2011, including project preparation; TA projects related to transport and renewable energy; and capacity building TA to improve management and operational effectiveness.

Lao P.D.R.: Asian Development Bank Commitments and Disbursements, 2001–11 1/

(In millions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Commitments	65.0	43.2	34.9	54.8	87.0	60.7	47.4	46.6	81.2	55.3	53.20
Disbursements	44.7	48.6	54.7	48.5	78.7	76.8	74.8	56.9	75.9	61.5	73.23

Source: Data provided by the Asian Development Bank.

1/ Starting from 2006, the commitments and disbursements included both loans and grants.

2/ The commitments and disbursements are as of December of each year

ANNEX IV. STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

General: Macroeconomic and financial data provided to the IMF have shortcomings that significantly hamper surveillance. Strengthening balance of payments (BOP) and national accounts statistics is a priority.

National accounts: National accounts comprise annual estimates of GDP by activity at current and constant base year 2002 prices, broadly following the System of National Accounts (SNA) 1993. Despite some improvements following the implementation of annual enterprise and household surveys, unresolved gaps and inappropriate data collection and compilation methodology continue to undermine the coverage and reliability of the GDP estimates. Lao P.D.R. participates in the IMF's Statistics Department (STA) project to implement the SNA and International Comparison Project (ICP), funded by the government of Japan, and has received technical assistance (TA) to improve annual national accounts and develop quarterly national accounts (QNA). Following the TA mission of December 12–21, 2011 under this project, the authorities launched the updating of the base year of their national accounts from 2002 to 2007 and this is planned for release in late 2012. It is expected that the QNA and parts of the 2008 SNA will be released in October 2014.

Prices statistics: Lao P.D.R. compiles a monthly CPI (December 2010=100) using weights based on the 2007/08 Lao Expenditure and Consumption Survey. To date no PPI has been developed. A TA mission was held on June 4–15, 2012 to improve the CPI and begin developing a PPI. The authorities have begun to develop a new PPI for LAO. It is expected that the new PPI will be released in July 2013. The mission was funded through the authorities' participation in the STA project to implement the SNA and ICP.

Government finance statistics: Government finance statistics remain weak. The timeliness of fiscal reporting needs significant improvement. Off-budget activities are not included in the fiscal data, although they have expanded rapidly. Annual budget and outturn data formats do not follow international standards. Except for the annual data disseminated in the Official Gazette, no fiscal data are disseminated in the country.

Monetary statistics: Regarding the compilation of monetary statistics, the classification of data by institutional sector and by financial instrument as well as valuation principles need to be strengthened. The Standardized Report Forms (SRFs), which embody the IMF-recommended framework for compiling monetary statistics need to be introduced. Financial soundness indicators should also be compiled and published. An STA mission to introduce the SRFs has been proposed, however, the authorities have not taken this up yet.

External sector statistics: The last TA mission was conducted in 2002. Lao P.D.R would be one of the beneficiaries of the recently approved Japan Administered Account (JSA) Project on the improvement of external sector statistics in the Asia and Pacific region. A TA mission on balance of payments statistics may take place in FY 2013.

Data Standards and Quality

Lao P.D.R. is not a General Data Dissemination System participant. No data ROSC is available.

Reporting to STA

Government finance statistics reporting for publication in the International Financial Statistics (IFS) and the Government Finance Statistics Yearbook, which was initiated in early 2009, is limited to budgetary central government and has been irregular and with long delays. Lao PDR reports quarterly and annual summary budget data in the *GFSM 2001* format for publication in *IFS* and the *GFS* Yearbook, with a time lag of six months or more, and on an irregular basis.

The reporting of monetary data is very irregular and also with long delays. Quarterly BOP data are reported once a year in a highly aggregated format. The last published data in the IFS and the Balance of Payments Statistics Yearbook correspond to 2010.

Table of Common Indicators Required for Surveillance

As of July 13, 2012

	Date of Latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]
Exchange Rates	06/29/12	06/29/12	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	Apr 2012	07/06/12	M	I	Q
Reserve/Base Money	Apr 2012	07/06/12	M	I	Q
Broad Money	Apr 2012	07/06/12	M	I	Q
Central Bank Balance Sheet	Apr 2012	07/06/12	M	I	Q
Consolidated Balance Sheet of the Banking System	Apr 2012	07/06/12	M	I	Q
Interest Rates[3]	Q4 2011	06/29/12	M	M	Q
Consumer Price Index	Jun 2012	07/12/12	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4]—General Government[5]	Q2 FY12	06/14/12	I	I	I
Revenue, Expenditure, Balance and Composition of Financing[4]—Central Government	Q2 FY12	06/14/12	Q	I	M
Stocks of Central Government and Central Government-Guaranteed Debt[6]			NA	NA	NA
External Current Account Balance	Q4 2011	07/12/12	Q	I	I
Exports and Imports of Goods and Services	Q4 2011	07/12/12	Q	I	I
GDP/GNP	2010/11	06/29/12	A	A	A
Gross External Debt	Dec 2011	06/29/12	M	M	I
International Investment Position[7]			NA	NA	NA

1 Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
2 Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency, but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency, but settled by other means.
3 Both market-based and officially-determined, including discount rates, money market rates, and rates on treasury bills, notes and bonds.
4 Foreign and domestic bank, nonbank financing.
5 The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
6 Including currency and maturity composition.
7 Includes external gross financial asset and liability positions vis-à-vis nonresidents.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 12/121
FOR IMMEDIATE RELEASE
October 18, 2012

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2012 Article IV Consultation with the Lao People's Democratic Republic

On August 31, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Lao P.D.R.[1]

Background

Despite policy tightening, global uncertainty, and natural disasters in Lao P.D.R. and its main trading partner, Thailand. real GDP growth remained strong at 8.0 percent in 2011 compared to an average of 7 percent per annum over the last decade. This has allowed the country to make significant progress with attaining Millennium Development Goals (MDG) targets. Inflation has moderated to 3.8 percent (y/y) in May 2012—reflecting lower food and fuel price pressures, policy tightening, and favorable base effects. The fiscal deficit declined further in 2011 to reach the pre-global financial crisis average. Credit growth, however, has again picked up to over 40 percent (y/y) in the first four months of 2012, reversing positive progress towards maintaining financial stability in 2011. The current account deficit has widened and gross international reserves declined by US$50 million to US$677 million at end-2011, covering about two months of prospective nonresource imports, the lowest level in almost a decade.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Macroeconomic policies have remained generally sound; however, low reserve coverage and rapid credit growth amid high lending rates have emerged as sources of vulnerability. Although the FY2013 budget targets a broadly unchanged fiscal stance, the prospect for rapid increases in civil service wages could crowd out higher priority spending going forward. Monetary policy remains accommodative and recently the Bank of Lao P.D.R. has tempered the sale of its securities, thus contributing to an increase in credit to the economy. The supervisory approach remains compliance-based and the entrance of new banks in recent years have spread supervision capacity thinly. Data gaps and poor data quality also hamper the ability to adequately monitor the economy and to design proactive policies to prevent macroeconomic vulnerabilities.

Structural reforms have been accelerated in the context of commitments under the ASEAN Economic Community and the prospect of World Trade Organization (WTO) accession. The authorities aim to complete entry conditions for WTO accession by year-end.

Executive Board Assessment

Executive Directors commended the authorities for their sound policies, which have contributed to impressive economic growth, reduction in poverty, lower inflation, and improved debt dynamics. Directors encouraged the authorities to take advantage of the favorable conditions to maintain macroeconomic and financial stability, build external and fiscal buffers, and achieve sustainable and broad-based growth.

Directors recommended a further tightening of monetary policy to help address the risks stemming from rapid credit growth. Quasi-fiscal lending to local governments should be phased out, and the pace of monetary expansion reduced through sterilization and higher reserve requirements. Directors also encouraged the authorities to strengthen the monetary policy framework and avoid pursuing multiple policy objectives. Moving to an explicit inflation target range in the medium term would help enhance the effectiveness of monetary policy and anchor inflation expectations. Directors stressed the importance of replenishing international reserves, to be supported by tightening macroeconomic policies and taking advantage of the prospective large capital inflows.

Directors emphasized the need to strengthen banking supervision to maintain financial sector stability. Improving the regulatory and prudential toolkit will ensure the quality of credit amid financial deepening. They encouraged the authorities to participate in the Financial Sector Assessment Program in due course, and welcomed the efforts underway to address the shortcomings in the Anti- Money Laundering/Combating the Financing of Terrorism (AML/CFT) regime.

Directors welcomed the commitment to prudent fiscal policy and to build buffers to deal with future shocks. They encouraged the authorities to exercise restraint in civil service wage increases which could crowd out higher priority spending. Directors recommended anchoring fiscal goals around the nonmining deficit. They welcomed the establishment of the State Accumulation Fund sourced by excess revenues and underspending, which will strengthen the ability of the budget to respond to future shocks. Directors recognized the improved debt sustainability assessment and called for further strengthening of the debt management framework and maintaining prudent borrowing policies.

Directors welcomed the authorities' reform efforts to achieve sustainable and inclusive growth. Improvements in the business climate, under the umbrella of WTO accession and the ASEAN Free Trade Agreement, will be key to enhancing competitiveness in the nonresource sector, while stepped up efforts to strengthen public financial management will create more space for high impact spending. Directors also noted the importance of improving the quality of data. They agreed that technical assistance by the Fund would support the authorities' reform agenda.

Lao P.D.R.: Selected Economic and Financial Indicators, 2009–13

	2009	2010	2011 Est.	2012 Proj.	2013 Proj.
GDP and prices (percentage change)					
Real GDP growth	7.5	8.1	8.0	8.3	8.0
CPI (annual average)	0.0	6.0	7.6	5.1	6.8
CPI (end year)	3.9	5.8	7.7	5.3	6.2
Public finances (in percent of GDP) 1/					
Revenue	17.1	18.0	18.1	19.3	19.5
Of which: Mining	2.1	1.8	2.4	3.1	3.0
Of which: Hydro power	0.8	0.8	0.8	0.8	0.9
Of which: Grant	2.3	2.3	2.2	1.9	1.8
Expenditure	24.1	22.7	21.0	21.8	22.1
Expense	12.9	12.3	12.0	12.3	14.0
Net acquisition of nonfinancial assets 2/	11.2	10.4	9.1	9.5	8.1
Net lending/borrowing	-6.9	-4.6	-3.0	-2.5	-2.5
Nonmining balance 3/	-9.0	-6.4	-5.4	-5.5	-5.5
Money and credit (annual percent change)					
Reserve money	25.1	48.6	16.2	16.6	7.7
Broad money	31.2	39.1	24.9	25.3	20.5
Bank credit to the economy 4/	90.7	46.0	38.2	32.1	17.5
Balance of payments					
Exports (in millions of U.S. dollars)	1,521	2,196	2,529	2,737	2,902
In percent change	-5.5	44.4	15.2	8.2	6.0
Imports (in millions of U.S. dollars)	2,893	3,582	4,603	5,202	5,955
In percent change	2.0	23.8	28.5	13.0	14.5
Current account balance (in millions of U.S. dollars)	-1,174	-1,256	-1,773	-2,026	-2,464
In percent of GDP	-21.0	-18.3	-21.4	-21.9	-24.0
Gross official reserves (in millions of U.S. dollars)	633	728	677	723	780
In months of prospective goods and services imports 5/	2.5	2.6	2.2	2.1	2.1
External public debt and debt service					
External public debt					
In millions of U.S. dollars	3,139	3,539	3,685	3,993	4,333
In percent of GDP	56.0	50.3	44.3	43.8	43.1
External public debt service					
In percent of exports	4.9	4.3	3.2	4.7	4.6
Exchange rate					
Official exchange rate (kip per U.S. dollar; end-of-period)	8,478	8,040	8,002	…	…
Real effective exchange rate (2000=100)	119.1	126.5	133.1	…	…
Nominal GDP					
In billions of kip	47,562	56,523	66,515	75,383	86,736
In millions of U.S. dollars	5,597	6,855	8,302	…	…

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.

1/ Fiscal year basis (October to September).

2/ Includes off-budget investment expenditures.

3/ Net lending/borrowing excluding mining revenue.

4/ Includes Bank of Lao P.D.R. lending to state-owned enterprises and subnational levels of government.

5/ Excludes imports associated with resource projects.

Statement by Mrs. Aida Budiman, Alternate Executive Director for Lao P.D.R. and Mr. Soulysak Thamnuvong, Advisor to Executive Director

August 31, 2012

1. As always, Lao authorities appreciate the constructive policy discussions and valuable advice provided by the Mission Team during the 2012 Article IV consultation. This year's Article IV consultation was particularly important due to the fact that Lao PDR concluded its second Poverty Reduction Strategy Paper (PRSP) for 2011-2015 which culminated into the adoption of the Seventh National Socio Economic Development Plan (NSEDP). Given the need to reduce poverty and achieve the objectives of the other MDGs by 2015 as well as to exit from the country status as Least Developed Country (LDC) by 2020, the authorities share the focus of the discussion on maintaining macroeconomic and financial stability while building the foundations for more broad-based growth.

Recent Economic Development and Outlook

2. Lao PDR performed better-than-expected during the sixth NSEDP or the first PRSP with annual average economic growth reaching 7.9 percent, as against the target of 7.5 percent. The poverty headcount was dropped from 46 percent in 1992/93 to 28 percent in 2007/08 and is expected to attain the related MDG target of 25 percent by 2015. Nevertheless, the authorities noted that there are some remaining issues and multiple challenges in meeting the MDGs, as also pointed out in the Joint Staff Advisory Note (JSAN). These remaining issues and challenges being addressed in the second PRSP. Reflecting the authorities' strong commitment to tackle poverty issues, the second PRSP places poverty eradication as one of the main strategic orientations. The Plan also focuses on macroeconomic stability and promoting inclusive and sustainable private sector led growth and regional integration, as well as sets ambitious but achievable targets and objectives. It sets the goal of attaining a GDP growth rate of at least 8 percent annually to allow a GDP per capita level of at least US$1,700 by 2015.

3. Despite the global uncertainty and domestic challenges, the economy continued to achieve a vibrant GDP growth of 8.0 percent in 2011, which is the first year of implementation of the second PRSP. The economic expansion was propelled by the industrial sector, particularly mining, electricity and manufacturing, and the services sector. Economic growth is expected to remain robust in 2012 reaching 8.3 percent on the strength of the expected recovery in agricultural and construction sector as well as appropriate policy mix. The favorable economic performance is expected to be sustained over the medium-term in line with the targets of the seventh NSEDP.

4. After peaking at 9.8 percent (y/y) in April 2011, the CPI Inflation has trended down reaching 7.6 percent in 2011 and 2.9 percent in July 2012. This favorable development was owed to abated pressures from domestic agricultural supply shocks caused by flooding brought by Nokten and Haima storms, and easing of global oil and commodities prices. At the same time, some policy tightening was put in place to

address inflationary expectations. Inflation is projected to average 5.1 percent in 2012, which is in line with the Bank of the Lao PDR's (BOL) target. The Kip exchange rate remains stable. After recording normal fluctuation against the US$ and Baht in 2011, Kip has depreciated against the US dollar by 0.07 percent, and appreciated against the Baht by 4.7 percent during the first semester 2012. Meanwhile the international reserve level has improved steadily and expected to be higher by the end of 2012.

5. The authorities continue to consider fiscal consolidation as a priority. The overall fiscal deficit moderated to 3.0 percent of GDP in FY11 from 4.6 percent of GDP in FY10, due to expenditure restraint and buoyant mining and hydropower revenues, while VAT revenue over-performed. The authorities expect the overall budget deficit to narrow to 2.5 percent of GDP in FY12 and maintain this level of deficit over the medium term. Credit growth has also slowed down markedly from 90.7 percent in 2009 to 44.5 percent in April 2012; Credit growth is expected to decelerate further to about 32 percent by the end of year. Given the rise in credit growth, albeit at a decelerating pace, the authorities continuously strengthen prudential regulation and banking supervision. Another notable progress was in the area of external debt sustainability which concluded that Lao PDR has been upgraded from a high risk to a moderate risk of debt distress country. This is due to the strong economic performance and continued improvement in public debt management by the authorities.

6. The authorities remain committed to pursue structural reforms and mobilize foreign investments. The broad-based and sustained economic growth underpinned by domestic and external macroeconomic stability is key in raising general living standards, achieving further progress in poverty reduction, and meeting the MDGs goals. This is the principal objective that guides the authorities in formulating and implementing their policies to deliver the greatest benefit for the Lao people. They noted that this year's discussions have contributed greatly in helping the authorities evaluate the appropriateness of their strategy and have provided valuable inputs for improvement.

Fiscal Policy

7. The authorities are committed to continue fiscal consolidation through continued tax reform and improved customs administration, as well as public finance management. The authorities' performance in fiscal consolidation has been encouraging as reflected by the continued moderation in fiscal deficit and firm commitment to maintain a 2.5 percent of GDP deficit level over the medium term.

8. The authorities view that an increase in the civil service wage bill in FY12 needs to be implemented since the wage freeze had been in effect for several years. The adjustment is important not only to compensate the increased cost of living but also to contribute to public governance improvement and provide incentive for civil servants to prevent brain-drain. Noting the unintended consequences of this action, the authorities commit to carefully monitor spending so as not to overcrowd other

important expenditures and coordinate with related ministries to mitigate its impact on inflation.

9. Realizing the need to build fiscal room, the authorities have established the State Accumulation Fund (SAF) this year, which will be managed under a new State Revenue Department of the MOF. The resources of SAF will be sourced from fiscal saving, either from revenue over-performance including higher share of mining revenue or from under-spending. The funds from SAF will be used for unforeseen circumstances, such as natural disasters or counter cyclical policies.

10. The authorities are of the view that public sector debt is well managed. Financing is important to deliver the PRSP goal for the economy but it has been done in prudent manner. Public debt in terms of GDP is expected to decline gradually and the country's risk of debt distress has been reclassified from high to moderate. The authorities welcome and note that the improved debt distress rating will have important implications for Lao PDR's borrowing capacity. In particular, it is expected that the overall envelope of external resources available to the country could potentially increase to meet the country's increasing financial needs for socio-economic development. In terms of debt reporting system, the authorities are currently in the process of finalizing the Debt Management and Financial Analysis System (DMFAS). The DMFAS will enable the authorities to record public debt data accurately and in a timely manner, including the disbursement schedule. The system is currently in the final stage of data entries and planned to be effective by the end of this year. The UNCTAD mission is scheduled to verify and validate the system by mid-September 2012.

Monetary and Exchange Rate Policies

11. Monetary policy has been geared to achieve and maintain price stability. The authorities believe that the current monetary policy settings are generally appropriate. While authorities recognize that there are still room to improve the efficiency of open market operations and liquidity forecasting, they stressed that in the conduct of monetary management they always take into account liquidity condition and the Kip exchange rate movement. They note the staff's advice to contain the expansion of the central bank net domestic assets (NDA) by accelerating the exit from quasi-fiscal lending. In fact, since the beginning of last year the BOL has restrained its quasi-fiscal lending by providing loans only for a few necessary and productive projects to improve the domestic supply of goods, with decreasing amount in the period ahead. Likewise, BOL's loan to local governments is expected to be gradually phased out.

12. In the current framework setting, the BOL securities are considered as the most efficient instrument in conducting monetary policy. It also plays an important role to promote interbank operations and help liquidity management in the banking system in the Lao context. The BOL takes note of staff's recommendation on issuing additional BOL securities but will consider carefully on implementation. Taking into account

the current condition, the BOL views that an increase in the reserve requirement ratio is the last resort to be considered. Over the medium-term, the authorities indicated that an implicit inflation target range will be considered once the monetary policy framework is sufficiently strengthened.

13. The authorities continue pursuing a managed floating exchange rate regime as the main instrument to maintain monetary stability. In this regard, the authorities appreciate staff's assessment on exchange rate policy that a stabilized exchange rate regime remains the appropriate monetary anchor since this regime has contributed greatly to overall macroeconomic and financial stability as well as promoting the greater use of Kip. The BOL continues to promote active FX interbank market operations and further liberalize foreign exchange policy. This liberalization aims at reinforcing public confidence and eliminating the FX parallel market eventually.

14. The authorities shared the importance of building the reserve level to improve the policy room. However, the authorities believe that recent international reserves coverage remains sufficient based on their measurement of imports. They have a fruitful discussion with staff on the appropriate measurement of imports and found scope for further improvement in this regard. With the strong prospect of FDI and ODA, including the plan to sell land titles valued in foreign exchange by the end of 2012, it is expected that the international reserves coverage level will further improve.

Financial and Banking Issues

15. With the current rapid expansion of financial sector, the authorities remain committed to strengthening supervision to support financial soundness. Currently, the banking condition remains sound with adequate capital, low NPL and regular banking supervision/examination. The BOL is well aware of keeping the pace of strengthening prudential regulations and supervisions in line with the financial development. They have taken steps to safeguard financial sector soundness by increasing the minimum capital adequacy ratio from 8 to 12 percent and issuing a new regulation on loan classification and provision requirement. The authorities are more optimistic on credit growth as it is reflective of a welcome financial deepening process (credit over GDP ratio has increased from 23 percent in 2009 to 39 percent in 2012) and accompanied by proper prudential regulation and continued improvement on banking supervision. They see the important role of FSAP in guiding a sound and rigorous financial sector development but would like to concentrate on improving data and other necessary condition before launching to that stage.

16. To address the shortcomings in the AML/CFT indentified in the 2011 evaluation by APG, an AML/CFT law is currently being drafted. In this regard, the authorities have requested and expect valuable inputs from the Fund before submitting the draft law to the National Assembly (NA) by the end of year.

Structural Reforms

17. The authorities have accelerated structural reforms to help improve business climate and build broad-based and inclusive growth. Commitments under the AFTA and the prospect of WTO accession had led to significant revisions of laws and the regulatory regime. Progress has been made in streamlining business registration procedures and preparing the investment promotion law; trade-related legislation is expected to be approved by the NA in September; the WTO accession would be finalized by end-2012. These could help enhance competitiveness and diversify the economic growth engine.

18. In conjunction with these efforts, the authorities continue working on modernizing and upgrading the quality and availability of economic and financial data. The statistics law and the statistics strategy for 2010-2020 are now in place, while the implementing decree passed in the Government meeting. This decree has been further amended and will be submitted to the Ministry of Justice for consideration and approval. Currently, the National Statistics Bureau is in a process of forming its team to work with the World Bank to launch a Lao statistics project, which will include 4 main components: (i) improvement of regulatory framework and other related regulations, (ii) enhancement of basic infrastructure of the statistics, (iii) development of data collection and analysis, and (iv) ICT system upgrade.

19. In addition, the BOL has recently accepted to participate in the project on the improvement of external sector statistics in the Asia Pacific region, which is the first project that will be held at the newly established TA office for Lao PDR and Myanmar in Bangkok.

Conclusion

20. The authorities continue to show their strong commitment to pursue the macroeconomic and financial stability while delivering a more inclusive growth for the economy guided by the seventh national socio-economic plan 2011-2015. That said, they understand that there would be an arduous road to achieve the goals stated in the Plan. Moreover, some goals will need longer-term to yield the benefits. They acknowledge that these goals are important to accelerate economic development and deliver a better and inclusive welfare for the Lao people. Thus, the authorities appreciate the Fund's continuous engagement, timely advice and policy recommendations. They also call for appropriate technical assistance from the Fund in various areas. They look forward to enhancing the already productive and warm relationship with the Fund and the international community in the near future.