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IMF Executive Board Concludes 2008 Article IV Consultation with the Lao People's Democratic Republic

On July, 30, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Lao People's Democratic Republic.[1]

Background

Lao P.D.R.'s economy has performed well in recent years, owing to generally stable macroeconomic conditions and a rapidly expanding natural resource sector. Real GDP growth has averaged more than 7 percent since 2004, with the resource sector (mining and hydropower) now accounting for more than half of total investment and exports. Inflation has moderated, and the kip has been allowed to strengthen. Despite a large external current account deficit, the overall external position has improved, given a sizable increase in private and official inflows. External public debt, as a share of GDP, also continues to decline in part due to improved fiscal performance and given strong economic growth.

In 2007, real GDP growth was nearly 8 percent, fueled by the resource (investment), tourism, and trading activity. Inflation picked up slightly, mainly reflecting global food and energy price trends, with the headline rate at around 5½ percent (year-on-year) at year end. The external current account deficit widened to more than 17 percent of GDP given a sharp rise in oil and capital imports, the latter associated with large resource projects. Gross official reserves

[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.

increased to US$539 million, or the equivalent of 3.7 months of prospective nonresource imports.[2]

Growth is projected to reach 7½ percent in 2008, driven by similar factors as last year, as well as higher mining output. So far, global economic weakness and financial turbulence have had limited impact on Lao P.D.R., but inflation pressures have continued to build. Headline inflation was 10¼ percent (y/y) in June 2008 and is expected to stay in the low double digits through the rest of the year, given recent trends in oil and food prices, but with aggregate demand pressures also now a factor. Monetary conditions have become more lax since 2007, due to large external inflows. Credit growth has also picked up considerably the past year—at 54 percent (y/y) in May 2008—with much of the growth attributable to state-owned commercial banks. However, fiscal performance continues to improve, with the overall budget deficit expected to decline by 1 percentage point in 2007/08 to 1.7 percent of GDP on higher resource and nonresource-related revenue.

Progress has been made on structural reforms, but much remains to be done. As a centerpiece of the government's banking reform strategy, the state-owned commercial banks continue to undergo an operational and financial restructuring, with non-performing loans (NPLs) declining sharply and banks beginning to recapitalize. Under the public finance management strengthening program, initial steps have been taken to recentralize fiscal authority and improve overall accountability, in line with the revised Budget Law. The government is also seeking ways to improve the financial performance of large state-owned enterprises, including through external audits.

The medium-term outlook for Lao P.D.R. remains positive, but hinges on sound development of the resource sector and other steps to strengthen competitiveness. The resource sector itself is expected to continue as a major driver of growth, although it poses potential fiscal risks and remains vulnerable to external shocks. Despite increasing mineral and electricity exports, the current account deficit is also projected to remain large over the next few years, on further increases in oil and capital imports, before beginning to moderate. More balanced and sustained high growth will require accelerated structural reforms, strengthened human capital, and sound infrastructure development, supported by enhanced capacity in macroeconomic and resource management. Under these conditions, external debt indicators should also continue to improve.

Executive Board Assessment

Executive Directors commended the Lao authorities for their prudent macroeconomic management and further progress on structural reforms, which have helped make the economy more resilient to the global slowdown and financial turbulence. Growth has continued to be strong, fueled by large-scale inflows into the natural resource sector, and the fiscal and overall

[2] Nonresource imports exclude those imports associated with large mining (gold and copper) and hydropower projects.

external positions have improved further. Directors noted that a combination of favorable commodity prices and growing regional demand for hydropower is expected to help improve the current account balance and sustain strong growth over the near to medium term. Nevertheless, they recognized that the authorities face new challenges as Lao P.D.R.'s economy enters a critical stage of development.

Directors stressed that longer-term growth prospects and job creation, particularly in the non-resource sector, will hinge importantly on a stable macroeconomic environment and a business climate that is conducive to foreign investment. They encouraged the authorities to persevere with sound macroeconomic policies and a strong reform agenda to help lower business costs, attract foreign investment, and improve competitiveness. Given the risks associated with the high level of external debt, Lao P.D.R. remains vulnerable to a deterioration in external conditions. Directors accordingly underscored the importance of prudent debt management, including by refraining from contracting non-concessional loans and strengthening control over quasi-fiscal risks.

Directors recognized the difficult challenge of maintaining macroeconomic stability amidst the rising oil and food prices. Large capital inflows have led to significant monetary expansion and rapid credit growth, adding to demand pressures and risking stability gains. Directors generally agreed that exchange rate appreciation has helped ease the burden of higher import costs, but encouraged the authorities to take further steps to tighten monetary policy in order to reduce inflationary pressures. In the near term, Directors recommended the use of the available indirect instruments to manage domestic liquidity, coupled with tighter prudential regulations to contain credit growth, in particular at state-owned commercial banks (SOCBs). They considered that the more flexible exchange rate policy, complemented with measures to deepen the foreign exchange market, will help underpin monetary tightening and enhance the economy's resilience to external shocks. Directors noted the staff's assessment that the real effective exchange rate is broadly in line with fundamentals.

Directors agreed that the fiscal stance aimed at further consolidation is broadly appropriate, and will contribute to reducing external vulnerability and containing demand pressures. This should be complemented by further reforms to broaden the tax base, and strengthen revenue collections and spending oversight. Directors encouraged the authorities to remain vigilant in recentralizing the government's fiscal authority. They suggested that the implementation of the new value-added tax should proceed carefully, underpinned by a reasonable timetable and sound technical preparations, and building on a broader reform of the tax system. It will also be important to reform the civil service and ensure that the government's wage bill is consistent with the available budget envelope and does not crowd out critical spending priorities.

Directors considered that sound development and management of the resource sector will be crucial, given its potential contribution to external viability, debt sustainability, and overall growth. Appropriate fiscal and regulatory regimes, as well as proper environmental standards, will help to maximize gains from sector development and improve governance. Directors accordingly called for the development of a comprehensive strategy for resource management, anchored in a medium-term fiscal framework, and welcomed the operationalization of the State

Accumulation Fund as a resource for addressing longer-term expenditure needs. Directors suggested that Lao P.D.R. participate in the Extractive Industries Transparency Initiative.

Directors welcomed the substantial progress in banking reform, notably the passage of the commercial bank law and the reduction of NPLs at SOCBs. Further steps will be necessary to restructure SOCBs and put in place proper risk management and controls to avoid a costly recurrence of NPLs and disintermediation by the banking system. Directors encouraged the central bank to continue to strengthen its regulatory and supervisory framework. Key elements in further progress will be the full implementation of the banking reform strategy and of the new banking law. It would also be important to bring the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework fully in line with international standards.

Directors noted that data deficiencies have hampered the surveillance process. They called on the authorities to give priority to improving balance of payments, national income, and external debt statistics, and to strengthen coordination among statistical agencies.

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Lao People's Democratic Republic: Selected Economic Indicators
(Annual percent change, unless otherwise indicated)

	2004	2005	2006	2007	2008 Proj.
GDP at constant prices	6.4	7.1	8.1	7.9	7.5
Inflation (CPI) (end year)	8.6	8.8	4.7	5.6	13.1
(Annual average)	10.5	7.2	6.8	4.5	10.8
Saving and investment (in percent of GDP)					
Gross national saving	12.9	13.0	20.1	21.6	18.3
Gross fixed investment	30.4	31.4	31.1	39.7	37.1
Public finances (in percent of GDP) 1/					
Revenue and grants	12.1	13.2	14.6	15.7	16.3
Expenditure	15.5	17.6	18.4	18.5	18.0
Overall balance (- deficit)	-3.3	-4.5	-3.8	-2.7	-1.7
Domestic financing	-0.3	0.2	-1.1	-1.1	-1.1
External financing	3.6	4.3	4.9	3.9	2.7
Broad money	22.8	7.7	30.1	38.7	38.9
Credit to the economy	9.0	7.6	-9.1	21.0	50.5
Balance of payments					
Exports (in millions of U.S. dollars)	536	684	1,143	1,203	1,516
Imports (in millions of U.S. dollars)	1,056	1,270	1,589	2,114	2,660
Current account balance (in percent of GDP)	-16.9	-17.8	-10.5	-17.4	-17.8
Gross official reserves (in millions of U.S. dollars)	226	238	335	539	789
In months of prospective nonresource imports 2/	2.7	2.4	3.0	3.7	4.9
External public debt (in millions of U.S. dollars)	2,105	2,203	2,308	2,446	2,589
In percent of GDP	83.9	76.9	66.0	59.5	49.3
GDP at current market prices (in billions of kip)	26,549	30,481	35,193	39,285	47,278

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.
1/ Fiscal year basis (October to September).
2/ Excludes imports associated with large resource projects.