



Office Memorandum

To: Members of the Executive Board

April 25, 2012

From: The Secretary

Subject: **Lao People's Democratic Republic—Assessment Letter for the World Bank**

Attached for the **information** of Executive Directors is the Fund's assessment letter on the macroeconomic conditions in the Lao People's Democratic Republic, which was requested by the World Bank.

If the authorities of Lao People's Democratic Republic consent to the publication of this assessment, it may be published by the World Bank.

Questions may be referred to Mr. Feridhanusetyawan, APD (ext. 35690).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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FO/DIS/12/70

Lao People's Democratic Republic—Assessment Letter for the World Bank
April 24, 2012¹

Lao P.D.R.'s growth remains strong and inflation has moderated, but the expansion of domestic demand is still putting pressure on the balance of payments and reserve coverage. The authorities have appropriately started to adjust fiscal and monetary policy, but further tightening is needed. Strengthening the macroeconomic policy framework and diversifying the export base remain essential to achieve sustainable and inclusive growth.

Despite global uncertainties and some policy tightening growth likely recorded

8.1 percent (y/y) in 2011. Growth was driven by mining and hydropower investments and construction activities, while the expansion in the services sector is indicative of resilient domestic demand. Inflation moderated to 7.7 percent (y/y) by end-2011 owing to slower food and fuel inflation despite the recent floods.

Strong domestic demand and real currency appreciation continue to create pressures on the balance of payments. Nonresource import growth outpaced export growth, reflecting strong domestic consumption, the impact of higher fuel and gas prices, and one-off factors. The real exchange rate has appreciated further during 2012, particularly in the second half as the Thai Baht depreciated. Gross international reserves declined by US\$50 million in 2011 to around US\$680 million, covering about two months of prospective imports. The joint IMF-World Bank external debt sustainability analysis concluded that Lao P.D.R. continues to face a high risk of debt distress.

The authorities have appropriately started to tighten the fiscal stance, although off-budget operations remain significant. Preliminary data indicate that the fiscal deficit narrowed from 4.6 percent of GDP in FY10 to 2.6 percent in FY11. Revenue performance continued to be buoyant on the back of higher mining and hydropower revenues, the expansion in registered VAT taxpayers, and higher excises from strong import growth.

The BOL's quasi-fiscal operations by providing loans to local governments continued, but its monetary impact has been mitigated by accelerating the sale of BOL securities. As a result, the growth of reserve money and broad money declined substantially to around 16 percent and 25 percent respectively by end-2011. Restraining the strong growth of credit to the private sector would help address concerns about a possible recurrence of NPL problems, especially given the low capital adequacy of some of the major SOCBs.

In the near term, further tightening of macroeconomic policies remains essential.

Tightening is needed to prevent further deterioration in the balance of payments position, contain inflationary pressures, and support a stabilized exchange rate regime. The nonmining fiscal deficit should be on a declining path over the medium term to taper demand-side pressures and bring public debt down from its currently elevated level. The BoL should strengthen the effectiveness of its monetary policy framework by gradually phasing out its

¹ The thrust of our assessment remains broadly consistent with the 2011 Article IV consultation. Our projections are preliminary and will be revisited during the upcoming Article IV Consultation from June 26–July 5, 2012.

quasi-fiscal operations while continuing to issue BoL securities, or consider raising the required reserve ratio, to control the growth of net domestic assets.

The medium-term outlook remains favorable, but further structural reform is needed to develop the nonresource sector and sustain poverty reduction. The risks to the outlook include the uncertainties in the global economic environment and volatile commodity prices, while potential vulnerabilities from the rapid development of the banking sector need to be addressed proactively. Structural reforms, including ongoing efforts to improve the business climate and trade integration, should be stepped up to support growth of nonresource sectors and poverty reduction. Creating fiscal space and enhancing the quality of government spending will also promote inclusive growth.

IMF Relations: The 2011 Article IV consultation was concluded by the IMF's Executive Board on July 8, 2011. The 2012 Article IV consultation is scheduled for late June and is expected to be discussed by the Board in late August. FAD and STA are providing technical assistance in several areas.

Table 1. Lao P.D.R.: Selected Social, Economic, and Financial Indicators, 2008–12

	2008	2009	2010	2011 Prel.est.	2012 Proj.
GDP and prices (percentage change)					
Real GDP growth	7.8	7.6	8.2	8.1	8.1
CPI (annual average)	7.6	0.0	6.0	7.6	5.3
CPI (end year)	3.2	3.9	5.8	7.7	5.6
Public finances (in percent of GDP) 1/					
Revenue	15.9	17.1	18.0	18.2	18.4
<i>Of which</i> : Mining	2.6	2.1	1.8	2.5	3.0
<i>Of which</i> : Hydro power	0.7	0.8	0.8	0.8	0.8
<i>Of which</i> : Grant	1.6	2.3	2.3	2.2	1.6
Expenditure	18.6	24.1	22.7	20.8	20.4
Expense	11.5	12.9	12.3	11.7	11.7
Net acquisition of nonfinancial assets 2/	7.1	11.2	10.4	9.1	8.7
Net lending/borrowing	-2.6	-6.9	-4.6	-2.6	-2.0
Nonmining balance 3/	-5.2	-9.0	-6.4	-5.1	-5.0
Money and credit (annual percent change)					
Reserve money	24.3	25.1	48.6	16.2	...
Broad money	18.3	31.2	39.1	24.9	...
Bank credit to the economy 4/	84.6	90.7	46.0	38.2	...
Balance of payments					
Exports (in millions of U.S. dollars)	1,609	1,521	2,217	2,760	3,123
In percent change	21.5	-5.5	45.8	24.5	13.2
Imports (in millions of U.S. dollars)	2,837	2,893	3,582	4,818	5,383
In percent change	31.5	2.0	23.8	34.5	11.7
Current account balance (in millions of U.S. dollars)	-979	-1,174	-1,226	-1,731	-1,861
In percent of GDP	-18.5	-21.0	-18.0	-21.0	-20.3
Gross official reserves (in millions of U.S. dollars)	636	633	728	677	714
In months of prospective goods and services imports 5/	3.7	2.5	2.4	2.1	2.1
External public debt and debt service					
External public debt					
In millions of U.S. dollars	2,949	3,109	3,491	3,682	3,998
In percent of GDP	55.7	55.5	51.4	44.7	43.6
External public debt service					
In percent of exports	4.3	4.9	4.5	4.6	4.4
Exchange rate					
Official exchange rate (kip per U.S. dollar; end-of-period)	8,466	8,478	8,040	8,002	...
Real effective exchange rate (2000=100)	122.9	119.1	126.5	133.1	...
Nominal GDP					
In billions of kip	46,215	47,567	56,014	65,973	74,785
In millions of U.S. dollars	5,293	5,598	6,793	8,234	...

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.