FOR AGENDA

SM/12/221

August 16, 2012

To: Members of the Executive Board

From: The Secretary

Subject: **Lao People's Democratic Republic—Staff Report for the 2012 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2012 Article IV consultation with the Lao People's Democratic Republic, which is tentatively scheduled for discussion on **Friday, August 31, 2012.** At the time of circulation of this paper to the Board, the authorities of the Lao People's Democratic Republic have indicated that they need more time to consider whether they will consent to the Fund's publication of this paper. Publication will only proceed upon the receipt by the Fund of the member's explicit consent. Any requests for modifications for publication are expected to be received two days before the Board concludes its consideration.

Questions may be referred to Mr. Botman (ext. 34214) and Ms. Duma (ext. 37583) in APD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the Asian Development Bank, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm) for the issuance date shown above.

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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

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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).

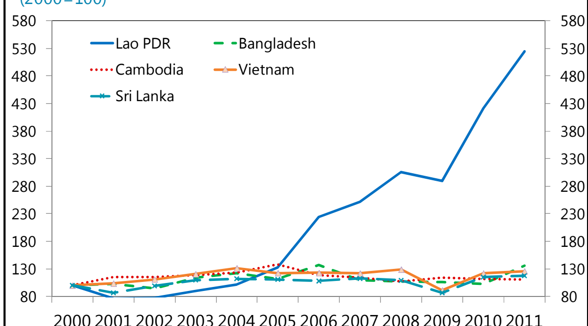
ECONOMIC CONTEXT

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.

Sources: Country authorities; and IMF staff estimates

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.



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

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 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. 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

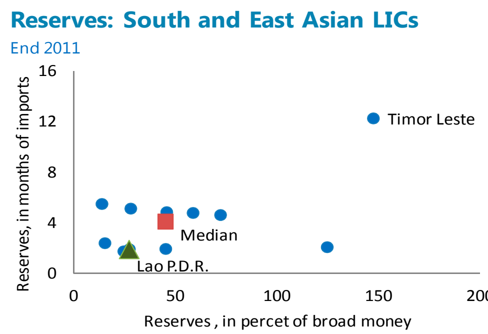
12. Policies will need to be sufficiently tight to avoid jeopardizing recent financial stability gains. Monetary policy and strong banking supervision are likely to be the "first line of defense" against excessive credit growth, but tighter fiscal policies will also contribute and reduce the current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

Box 1. Reserve Adequacy and Risks to External Stability

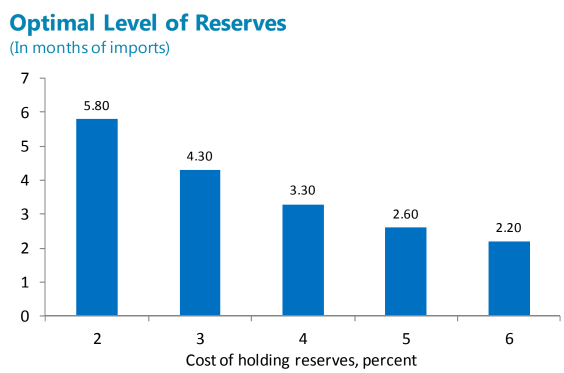
Traditional metrics indicate that, at current levels, Lao P.D.R.'s international reserves do not offer adequate protection against external shocks. Common rules of thumb suggest that reserves should cover at least three months of prospective imports or be equivalent to up to 50 percent of broad money. 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 nonexistent 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 the 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.

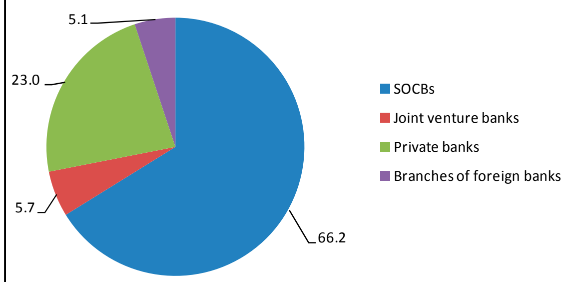
mainly of dollars and baht, but in the future other currencies might be added, further complicating the conduct of monetary operations.

B. Financial Sector: Strengthening Supervision to Support Soundness

Staff Views

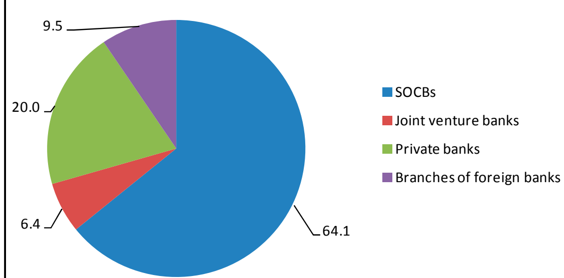
16. Rapid credit growth raises concerns about the health of the banking system. Stronger credit growth can be indicative of financial deepening, in itself a welcome development, provided that its pace is not excessive and improvements in regulatory and supervisory enforcement capacity stay ahead of the 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)



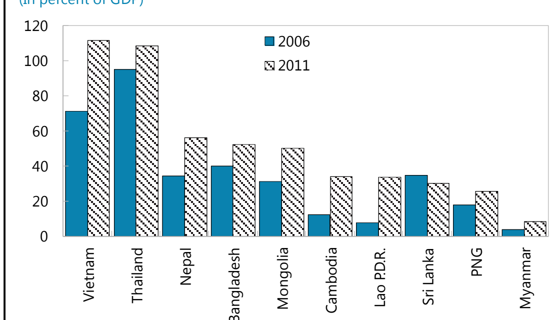
Sources: BoL; and IMF staff estimates.

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 these weaknesses came to the fore in 2011 when one of the private banks experienced a bank run 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.

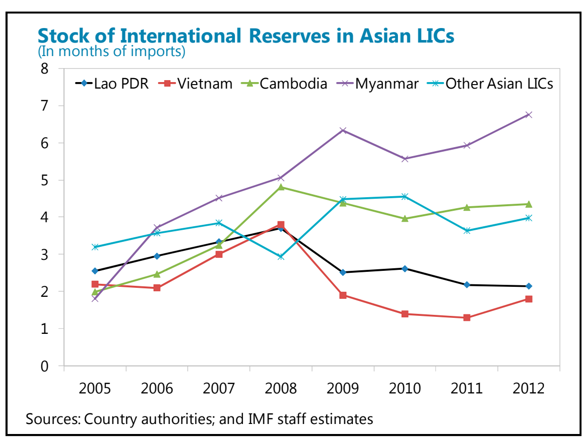
Authorities Views

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 were uncommitted on participation in the FSAP, but would consider requesting input from the IMF on the Anti Money Laundering 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

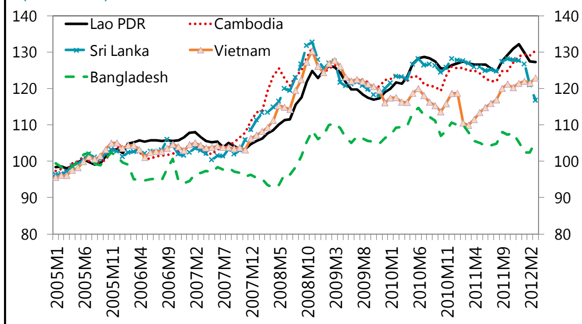
[5] Between 2002–07, the headline deficit averaged about 3 percent of GDP. A significant stimulus was implemented in 2009 that led to an increase in the deficit to close to 7 percent of GDP. Most was provided through the BoL, which disbursed funds directly to private contractors to finance local government's 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)



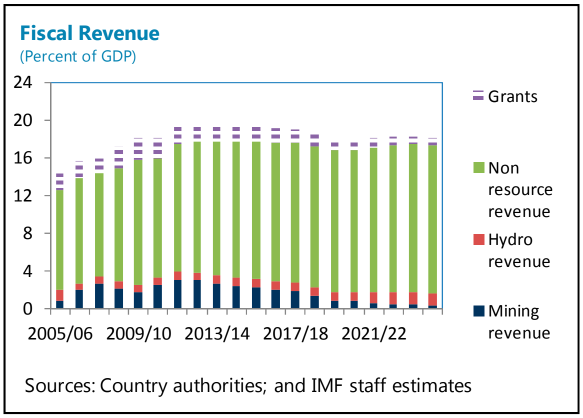
Sources: Country authorities; and IMF staff estimates

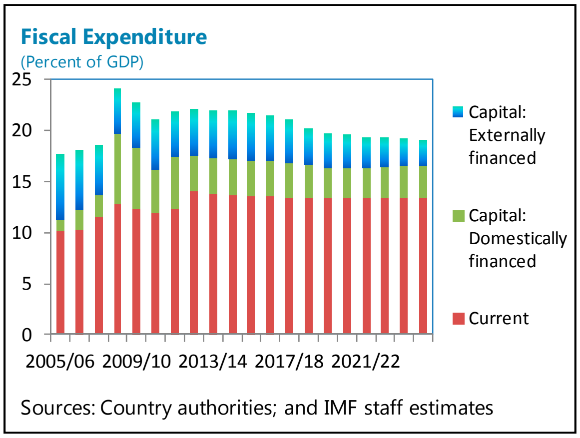
CGER Assessment of the Kip

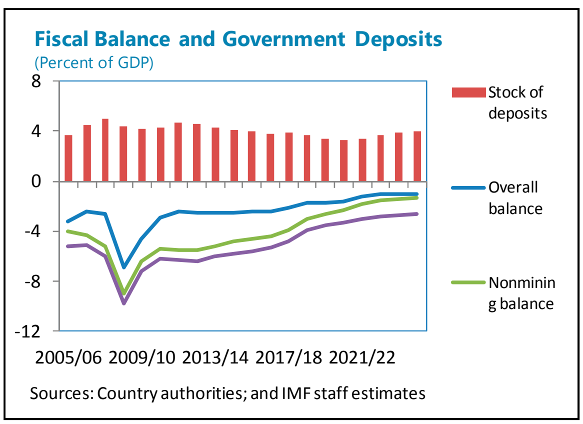
Approach	Estimated Overvaluation (in percent)
Purchasing power parity	4.6
Macro balance	16.2 to 31.2
Equilibrium exchange rate	-19.9
External sustainability	10.4 to 17.6

Source: IMF staff estimates.

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







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.

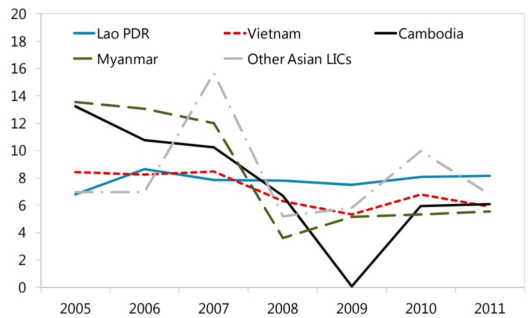
40. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

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.

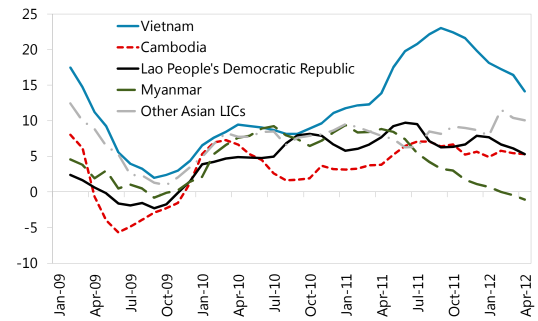
Growth has been strong and more stable compared to other LICs in Asia.

GDP Growth in Asian Low Income Countries
(In percent)



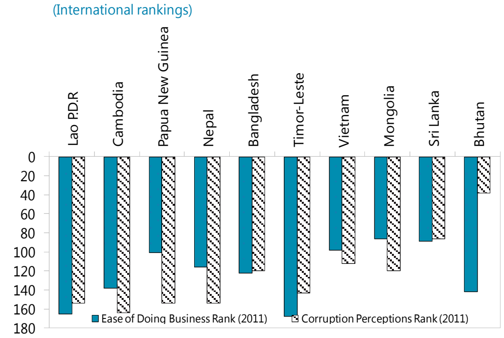
Inflation has largely been contained below 10 percent even as major commodity price shocks hit.

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



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

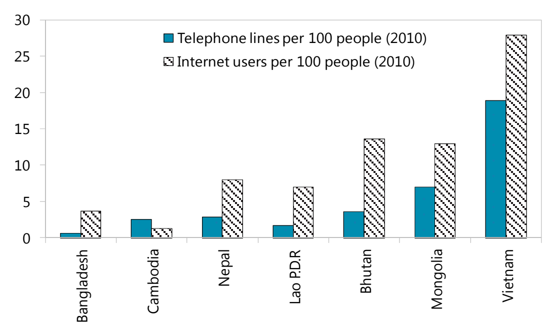
Hindrance to Investment
(International rankings)



Sources: WDI and Transparency International

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

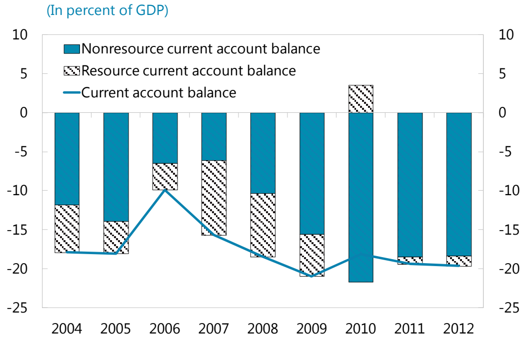
Infrastructure



Sources: WDI and Transparency International

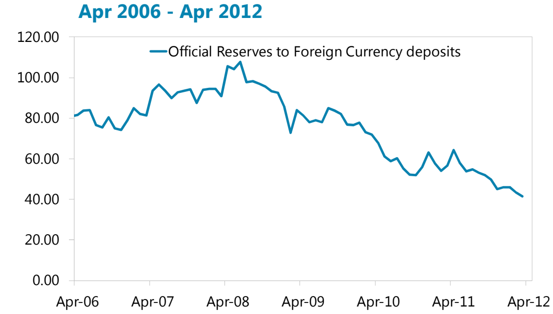
The nonresource current account deficit is estimated to have narrowed in 2011, partly reflecting the tightening of domestic policies.

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



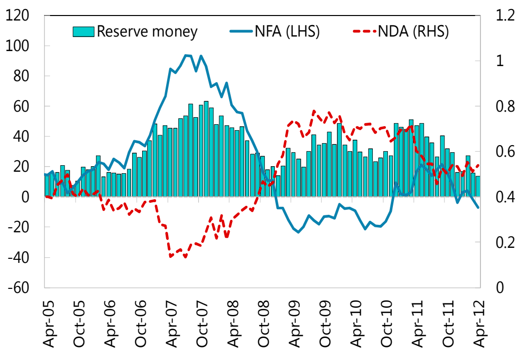
Sources: Country authorities; and IMF staff estimates

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

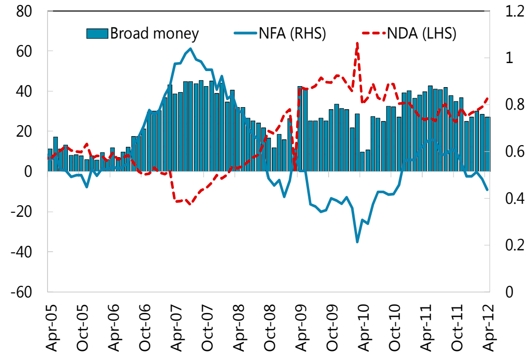
(Year-on-year percentage change)



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

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

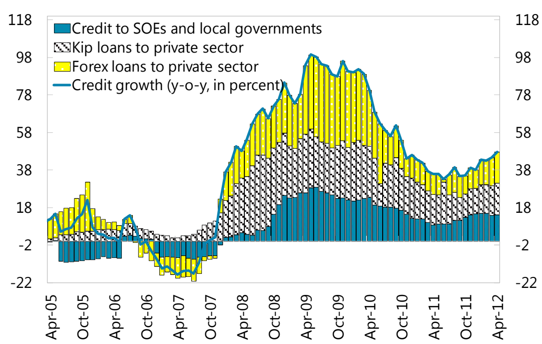
(Year-on-year percentage change)



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

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

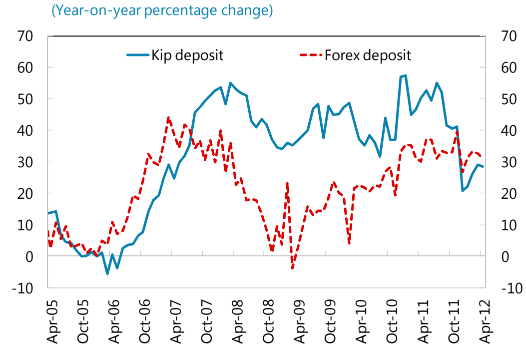
(Year-on-year percent change)



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

Deposit Growth, Apr.2005-Apr.2012

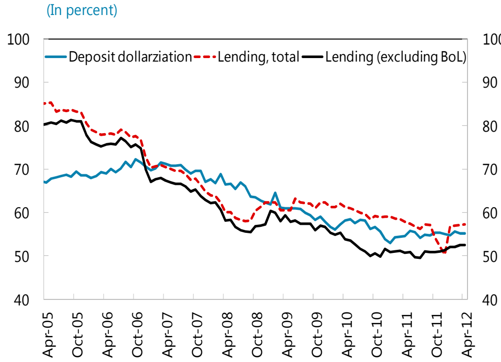
(Year-on-year percentage change)



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

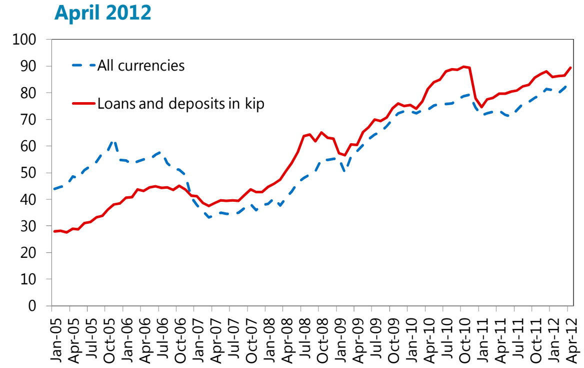
Dollarization, Apr.2005–Apr.2012

(In percent)



Overall, the ratio of loans to deposits increased.

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



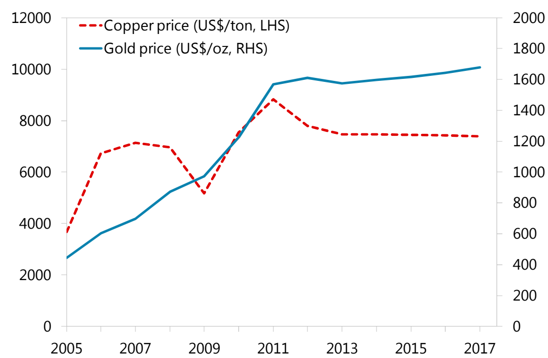
Sources: Country authorities, and IMF staff estiamtes

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.

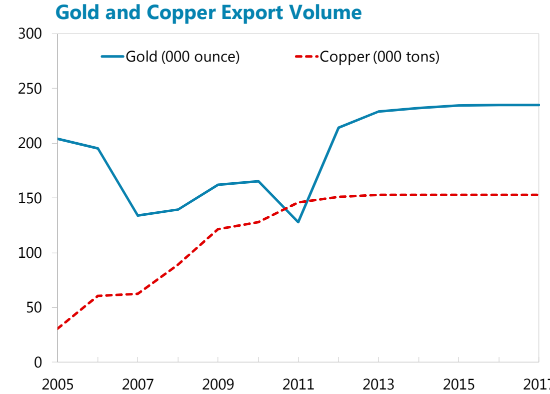
Copper and gold prices are exceptionally high and expected to remain strong.

Copper and Gold Price



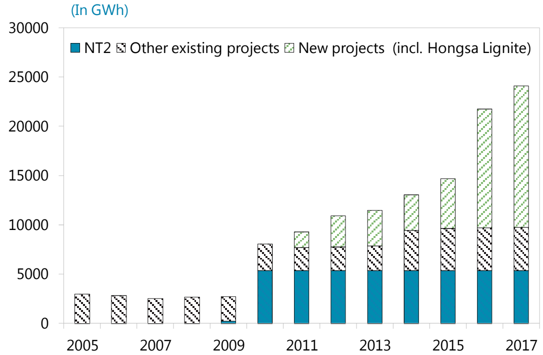
The medium-term prospect for mining production is favorable owing to recent expansion.

Gold and Copper Export Volume



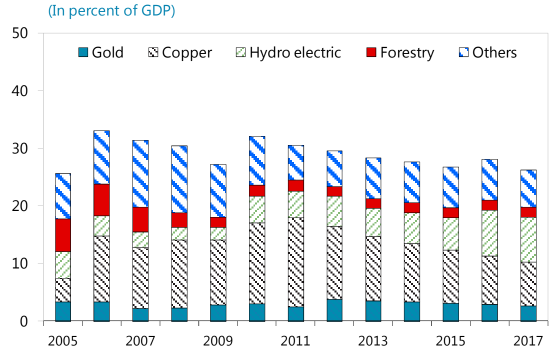
Hydro electric exports would increase substantially with the operation of new dams in the medium term.

Hydro Electric Export Volume
(In GWh)



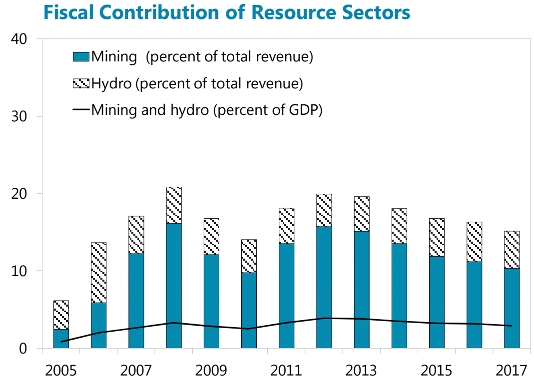
The resource sectors provide a large contribution to exports, but their role is expected to decline in the near future.

Export of Resource and Nonresource Sectors
(In percent of GDP)



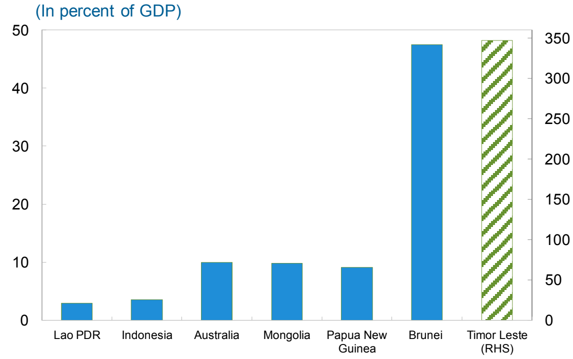
The fiscal contribution of the resource sectors remains large, but is also projected to decline in the medium term.

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

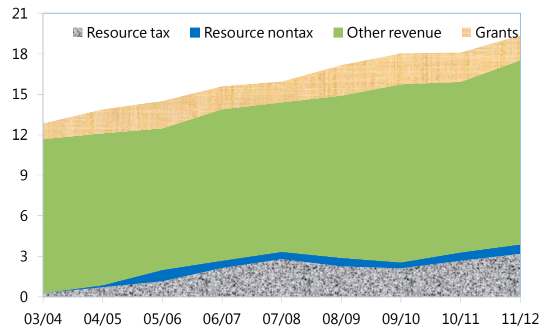
Figure 4. Lao P.D.R.: Fiscal Sector Developments and Outlook

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

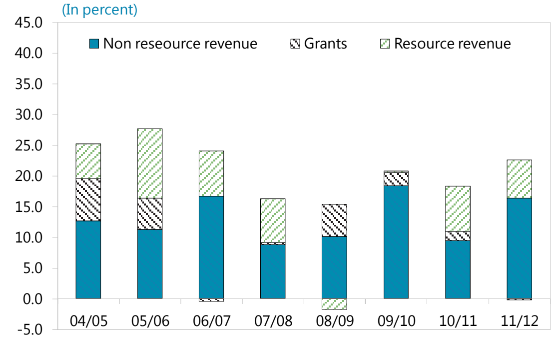
(in percent of GDP)



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

Contribution to Revenue Growth

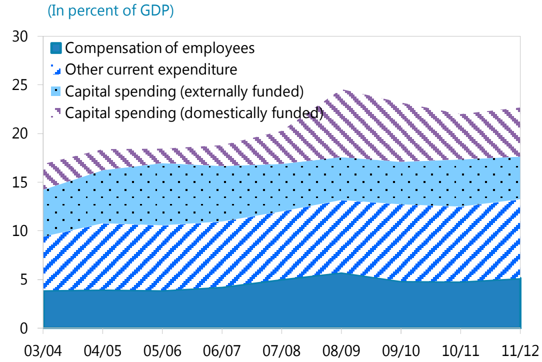
(In percent)



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

Government Expenditure

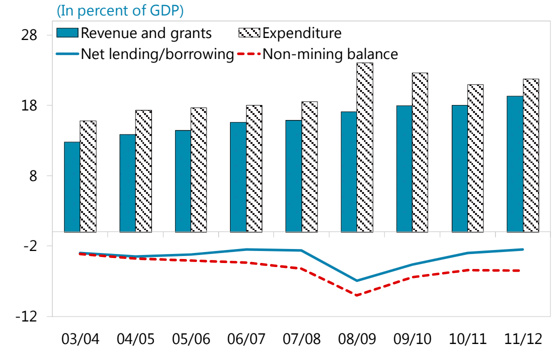
(In percent of GDP)



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

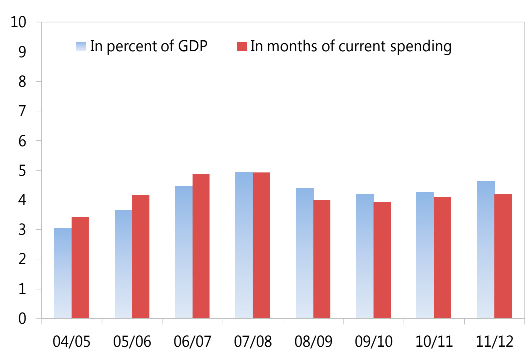
Fiscal Balance

(In percent of GDP)



The stock of government deposits remains comfortable…

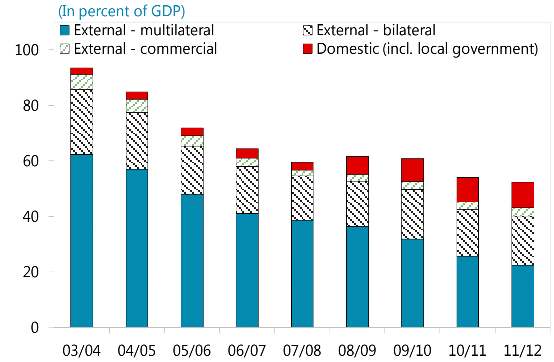
Stock of Government Deposits



…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	2012	2013	2014	2015	2016	2017
			Est.			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		2011/12		2012/13	
		Rev. Budget	Est.	Rev. Budget	Proj.	Prel. Budget	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).

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[August XX, 2012]

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APPENDIX: Draft Public Information Notice

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 the main trading partner Thailand, real GDP remained strong at 8.0 percent in 2011 compared to an average of 7 percent per annum over the last decade, allowing the country to make significant progress with attaining 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

[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.

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.

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

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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.