

**FOR
AGENDA**

SM/12/221
Supplement 1
Correction 1

August 30, 2012

To: Members of the Executive Board

From: The Secretary

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

The attached corrections to SM/12/221, Supplement 1 (8/16/12) have been provided by the staff:

Mischaracterizations of the Views of the Authorities

Page 7, para. 18, lines 1–8: for “Two main sources of disagreement are the nonrecognition of US\$600 million of disbursements from China over the medium term as well as the expected exchange rate depreciation built into the framework. The authorities did not acknowledge staff’s previous estimates of large disbursements of new funds from China between 2012 and 2017.”

read “The authorities highlighted that debt projections over the medium term remained imprecise and questioned the exchange rate assumptions built into the framework. On the basis of information provided by local contracting parties, the authorities anticipated a smaller increase in disbursements of new funds from some bilateral donors between 2012 and 2017 than assumed in the DSA.”

para. 18, footnote 7, lines 1–3: for “The staff maintained the \$600 million of estimated disbursements as this was information collected by previous missions.”

read “The staff maintained the US\$600 million of projected disbursements from China between 2012–2017, which is based on information collected by previous missions.”

Factual Errors Not Affecting the Presentation of Staff’s Analysis or Views

Page 2, para. 3, lines 1 and 2: for “Lao P.D.R.’s external PPG debt remains elevated,”
read “Lao P.D.R.’s external PPG debt remains elevated compared to other LICs in Asia,”

Page 3, para. 6, lines 17–19: for “in 2012 as the BoL’s quasi-fiscal operations are terminated.”
read “in the near future as the BoL’s quasi-fiscal operations are gradually phased out.”

Questions may be referred to Mr. Botman, APD (ext. 34214).

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

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LAO PEOPLE'S DEMOCRATIC REPUBLIC

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS¹

August 16, 2012

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

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

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

INTRODUCTION

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

Thresholds for External Debt (In percent)		
Threshold		
Indicator	Before	Now
Present value of debt to GDP	30	40
Present value of debt to exports	100	150
Present value of debt to revenue	200	250
Debt service to exports	15	20
Debt service to revenue 1/	25	20
Sources: Lao P.D.R. authorities; and IMF and World Bank staff estimates		
1/ For debt service to revenue ratio, the applicable thresholds have been reduced.		

the risk reclassification.

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

BACKGROUND AND ASSUMPTIONS

3. Lao P.D.R.'s external PPG debt remains elevated compared to other LICs in Asia, but its burden has eased considerably in the recent past. The nominal stock of PPG debt increased from US\$3.5 billion in 2010 to US\$3.7 billion in 2011. However, high real GDP growth and the Kip's appreciation vis-à-vis the U.S. dollar contributed to a decline in the debt-to-GDP ratio

from 50.3 percent of GDP to 44.4 percent of GDP in 2011. The corresponding net present value (PV) of debt at end-2011 was 29.8 percent of GDP, down from 36.6 percent of GDP in 2010. Similarly, the PV of PPG debt relative to exports declined from 85.9 percent in 2010 to 78.1 percent in 2011.

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

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

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

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

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

Lao P.D.R.: Stock of Public and Publicly Guaranteed External Debt at End-2011			
	In Billions of U.S. Dollar	As a Share of Total External Debt	In percent of GDP
Total	3.7	100	44.4
Multilateral	2.1	55.8	24.7
Bilateral	1.4	37.9	16.9
Commercial 1/	0.2	6.3	2.8
Sources: Lao P.D.R. authorities; and IMF and World Bank staff estimates			
1/ Includes direct borrowing by state-owned enterprises on nonconcessional terms.			

5. The increasing presence of bilateral creditors underscores the need to strengthen debt management capacity. This is particularly important to ensure that debt sustainability considerations are taken into account when new debt is contracted. A mitigating factor for Lao P.D.R.'s external debt burden lies in the prospective returns on the hydropower and mining projects that have been financed in part by external PPG debt. While many of these projects face construction and implementation

challenges, the long-term power purchase agreements that are signed for these projects and the resulting government revenues in the form of royalties, dividends, and profit tax payments arguably reduce the risk of debt distress.

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

Lao P.D.R.: External Public Debt Indicators at End-2011		
	Indicative thresholds	End-2011
Present value of debt, as a percent of:		
GDP	40	29.8
Exports	150	78.1
Revenue	250	182.9
Debt service, as a percent of:		
Exports	20	3.2
Revenue	20	7.5
Sources: Lao P.D.R. authorities; and IMF and World Bank staff estimates		

ASSUMPTIONS UNDERLYING THE DEBT SUSTAINABILITY ANALYSIS

7. Box 1 summarizes the medium-term macroeconomic framework underlying the DSA. The baseline scenario—which is based on current policies—projects annual average growth

of 7.9 percent between 2012 and 2017, in line with the authorities' targets. Growth would be supported by the strong performance of exports, especially from the resource sector, as well as by

buoyant domestic activity, in particular agriculture, manufacturing, and services. Improvements to the business climate and the continued transition towards a market-based economy will also

Lao P.D.R. Macroeconomic Assumptions: Comparison with 2011 (Average over the 20 year projection horizon)		
	2011 DSA	2012 DSA
GDP growth	6.7	6.8
GDP deflator in U.S. dollar terms (in percent)	3.3	2.1
Noninterest current account deficit	11.4	11.8
Primary deficit	0.3	0.7
Sources: Lao P.D.R. authorities; and IMF and World Bank staff estimates		

contribute to steady and more broad-based growth in Lao P.D.R.

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

DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

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

10. Exchange rate and shocks to the cost of new loans present the most important risks to external debt sustainability. Table 3 and Figure 1 illustrate how a one-off 30 percent depreciation of the kip vis-à-vis the U.S. dollar would lead to a sharp rise in the PV of the debt-to-GDP and the PV of debt-to-revenues, although in the last case the new policy-dependent

threshold is not breached. A rise in the cost of additional financing (by 200 basis points relative to the baseline) would increase the PV of debt-to-exports ratio by more than 30 percentage points in the long run relative to the baseline. However, even under this extreme scenario, there would be no breaches of the corresponding threshold, contrary to the results in the previous DSA when policy performance was still rated as weak. Hence, improved policy performance reduced the vulnerability of Lao P.D.R.'s external debt to potential shocks to the cost of public funds.

11. Debt dynamics continue to be markedly worse under an alternative scenario in which key variables are at their historical averages. Through 2015, debt dynamics are more favorable under this historical scenario—which takes into account the appreciation of the kip relative to the U.S. dollar experienced during 2002–2011⁶. In later years, this effect is

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

THE AUTHORITIES' VIEWS

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

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

CONCLUSION

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

20. These gains notwithstanding, results are still sensitive to assumptions regarding investment and performance of the resource sector. Despite long-term contracts with fixed prices for energy exports to neighboring countries, Lao P.D.R.'s economy remains exposed to fluctuations in copper and gold prices in the medium term, as well as to economic developments in its main trading partners (China,

Thailand and Vietnam).⁸ Lower growth in Lao P.D.R. and a weaker balance of payments would worsen debt dynamics. Thus, a tightening of macroeconomic policies can support external sustainability. Cautious assessment and monitoring of large-scale projects and private external debt will be required to mitigate the risks posed to external and public debt sustainability,

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

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

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

21. External borrowing should mostly be obtained on concessional terms and fiscal and quasi-fiscal liabilities should be carefully managed, to further create buffers against vulnerabilities. Improving debt management

capacity and developing a medium-term borrowing strategy for the government could also lead to more efficient utilization of borrowed funds and more favorable debt dynamics even under stress scenarios. If these conditions were to materialize, Lao P.D.R.'s risk of debt distress could improve even further.