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FOR AGENDA

SM/12/221
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**

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

Mischaracterization of the Views of the Authorities

Page 11, para. 18, lines 20–26: for "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"
read "The authorities said they would consider participation in the FSAP and continue to upgrade their systems in preparation for this. They also would consider requesting input from the IMF on the Anti Money Laundering/Combatting the Financing of Terrorism Law"

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

Page 6, para. 10, bullet 4: for "public sector debt remains elevated."
read "public sector debt remains elevated compared to other LICs in Asia."

Page 9, Box 2, para. 1, line 4: for "The interbank market is nonexistent"
read "The interbank market is rudimentary"

Page 9, Box 2, para. 3, line 1: for "The BoL lacks the operational independence"
read "The BoL lacks full operational independence"

Page 11, para. 18, line 25–26: for "on the Anti Money Laundering Law currently being drafted for"
read "on the Anti Money Laundering/Combatting the Financing of Terrorism Law currently being drafted for"

Evident Ambiguity

Page 10, para. 16, footnote 4: for "private banks experienced a bank run and the BoL had to" read "private banks experienced a bank run following a false rumor and the BoL had to"

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

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

Staff Views

9. Near-term prospects are generally favorable.

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

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

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

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

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

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

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

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

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

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

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

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

Authorities' Views

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

MAINTAINING MACROECONOMIC STABILITY

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

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

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

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

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

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

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

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

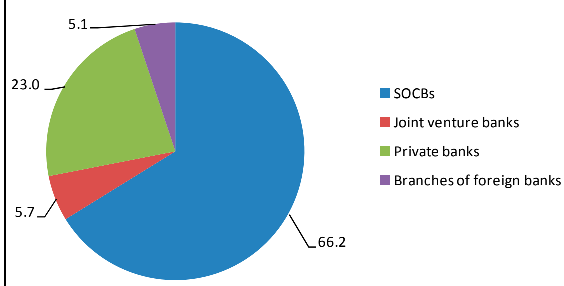
mainly of dollars and baht, but in the future other currencies might be added, further complicating the conduct of monetary operations.

B. Financial Sector: Strengthening Supervision to Support Soundness

Staff Views

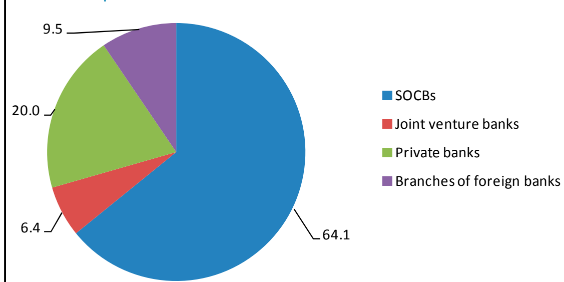
16. Rapid credit growth raises concerns about the health of the banking system. Stronger credit growth can be indicative of financial deepening, in itself a welcome development, provided that its pace is not excessive and improvements in regulatory and supervisory enforcement capacity stay ahead of the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

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



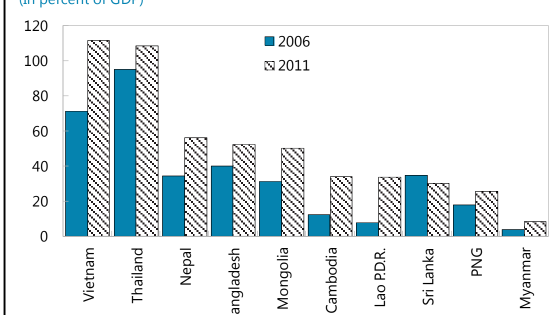
Sources: BoL; and IMF staff estimates.

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



Sources: BoL; and IMF staff estimates.

Credit to the Economy
(In percent of GDP)



Sources: Country authorities; and IMF staff estimates

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

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

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

Authorities Views

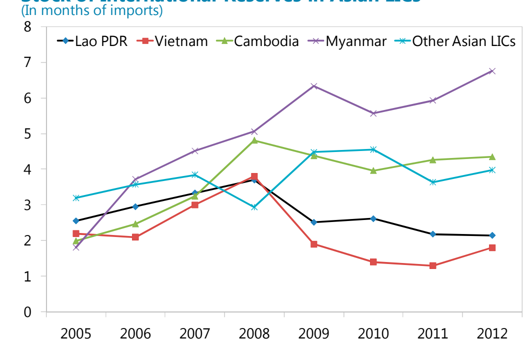
18. The authorities agreed that maintaining the credit quality is essential for sustainable growth, but were more sanguine about financial sector risks. They saw current credit growth in line with the overall objectives set out in the development plan. Furthermore, it had slowed substantially from the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

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

Staff Views

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

Stock of International Reserves in Asian LICs
(In months of imports)



Sources: Country authorities; and IMF staff estimates 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.