



Office Memorandum

To: Members of the Executive Board

June 4, 2013

From: The Secretary

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

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

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

Questions may be referred to Mr. Ahuja (ext. 35464) and Ms. Duma (ext. 37583) in APD.

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

Att: (1)

Other Distribution:
Department Heads

FO/DIS/13/76

**Lao People’s Democratic Republic—Assessment Letter for the World Bank
June 3, 2013¹**

Lao P.D.R. is growing rapidly, but to strengthen the external position and reduce financial sector vulnerabilities, a tightening of policies is warranted. Also, to ensure that growth is broad based and inclusive over time, the authorities should continue with structural reforms.

1. **Near-term growth prospects remain strong, with consumer price inflation relatively well-contained.** Economic growth is estimated at 8.3 percent in 2012, with notable contributions from wholesale and retail trade, electricity generation, and construction. Growth is expected at around 8 percent in 2013. Inflation has increased somewhat from below 5 percent at end-2012 to 5.5 percent (y-o-y) in April 2013 largely due to higher non-rice food prices (mainly beef) given supply shortages and is expected at about 7 percent in 2013. Non-food inflation remains moderate at around 2 percent in April.
2. **External buffers should be strengthened.** At around 1.3 months of imports (US\$0.7 billion), international reserves are relatively low. The real effective exchange rate has appreciated by around 5½ percent over the past twelve months, much of that from higher relative inflation in Lao P.D.R. Strong domestic demand and real currency appreciation have put some pressure on the balance of payments. Reflecting strong domestic consumption, nonresource import growth is expected to continue to outpace export growth. The current account deficit would widen further to 24 percent of GDP in 2013, from 22 in 2012.
3. **Monetary policy continues to be accommodative,** buoying domestic demand and nonresource imports, and contributing to financial sector vulnerabilities. Growth of the central bank’s net domestic assets remained strong at end-2013 (38.5 percent y-o-y). Private sector credit was also strong at around 35 percent (y-o-y) at end-2012. Official financial sector indicators are sound, but rapid credit growth and appreciation in collateral value could mask underlying vulnerabilities. We continue to reiterate the need to contain credit growth.
4. **The fiscal stance is appropriate, but there are risks that fiscal consolidation could be delayed.** At 2.5 percent of GDP, the fiscal deficit was broadly appropriate in 2012 but going forward, there are risks that this could be higher if public sector wages rise. Wages and compensation could rise to about 61 percent of recurrent spending compared to 58 percent in FY2011/2012. This has the potential to limit the scope of fiscal policy to respond to future shocks and crowd out higher priority spending. Revenue performance remains buoyant on the back of higher mining and hydropower revenues, the expansion in registered VAT taxpayers, and higher excises from strong import growth.
5. **Risk of debt distress could intensify from recently announced infrastructure mega-projects.** The 2012 debt sustainability analysis assessed the risk of debt distress to be moderate. However, the government recently signed a memorandum of understanding (MOU) with a Malaysian firm to undertake a US\$5 billion (around 50 percent of GDP) high-

¹ The thrust of our assessment remains broadly consistent with the 2012 Article IV consultation.

speed railway project connecting Laos with Vietnam. Details have not yet been made public and information on this project is being sought.

6. **To strengthen external and fiscal buffers, macroeconomic policies should be tightened in the near term.** This is necessary to prevent further deterioration in the balance of payments position and support a stabilized exchange rate regime. Wage bill increases should be moderated and the nonmining fiscal deficit put on a declining path over the medium term to temper domestic demand. This should help towards attaining a more favorable level of debt. Monetary policy should also be tightened in an incremental fashion by raising the interest rates and the required reserve ratio. Quasi-fiscal lending to local governments by the Bank of Lao P.D.R. has ceased, but the central bank should begin unwinding this operation. Strengthening banking supervision by shifting from a compliance-based approach to one that adequately addresses risks is critical towards having healthy credit growth.

7. **The medium-term growth outlook remains favorable, but growth should be more inclusive.** Reforms should aim at making growth more broad-based by enhancing competitiveness in the nonresource sector. For this to be achieved, it will be necessary to accelerate Public Financial Management (PFM) reforms and improve the investment climate to enable diversification of the economy. Creating fiscal space and enhancing the quality of public service delivery, particularly in the areas of health and education, will support the promotion of inclusive growth.

8. **IMF Relations:** The 2012 Article IV consultation was concluded by the IMF's Executive Board on July 5, 2012. The 2013 Article IV consultation mission is tentatively scheduled for August 2013. FAD and STA are providing technical assistance in several areas.

Lao P.D.R.: Selected Economic and Financial Indicators, 2010–14 ^{1/}					
	2010	2011	2012	2013	2014
			Est.	Proj.	
GDP and prices (percentage change)					
Real GDP growth	8.1	8.0	8.3	8.1	7.8
CPI (annual average)	6.0	7.6	4.3	7.3	4.6
CPI (end year)	5.8	7.7	4.7	6.4	5.1
Public finances (in percent of GDP)					
Revenue	18.0	18.1	19.4	19.6	19.5
<i>Of which</i> : Resources	2.5	3.3	3.9	3.8	3.5
<i>Of which</i> : Mining	1.8	2.4	3.1	3.0	2.6
<i>Of which</i> : Hydro power	0.8	0.8	0.8	0.9	0.9
<i>Of which</i> : Grant	2.3	2.2	1.9	1.8	1.8
Expenditure	22.7	21.0	21.9	22.2	22.1
Expense	12.3	12.0	12.4	14.0	13.9
Net acquisition of nonfinancial assets 2/	10.4	9.1	9.6	8.1	8.3
Net lending/borrowing	-4.6	-3.0	-2.5	-2.6	-2.6
Nonmining balance 3/	-6.4	-5.4	-5.5	-5.5	-5.2
Money and credit (annual percent change)					
Reserve money	48.6	16.2	27.2	14.2	10.1
Broad money	39.5	28.7	31.0	25.9	18.7
Bank credit to the economy 4/	48.4	45.8	26.6	23.9	18.6
Bank credit to the private sector	48.4	39.3	35.1	33.0	24.0
Balance of payments					
Exports (in millions of U.S. dollars)	2,196	2,529	2,738	2,898	3,097
In percent change	44.4	15.2	8.3	5.9	6.9
Imports (in millions of U.S. dollars)	3,582	4,603	5,184	5,958	6,453
In percent change	23.8	28.5	12.6	14.9	8.3
Current account balance (in millions of U.S. dollars)	-1,256	-1,773	-2,008	-2,472	-2,686
In percent of GDP	-18.3	-21.4	-21.8	-24.0	-24.0
Gross official reserves (in millions of U.S. dollars)	728	677	740	790	899
In months of prospective goods and services imports	1.8	1.5	1.4	1.4	1.6
(Excluding imports associated with large resource projects)	2.6	2.2	2.2	2.1	2.2
External public debt and debt service					
External public debt					
In millions of U.S. dollars	3,539	3,685	3,993	4,333	4,716
In percent of GDP	50.3	44.3	43.9	43.1	42.2
External public debt service					
In percent of exports	4.3	3.2	4.7	4.6	4.7
Exchange rate					
Official exchange rate (kip per U.S. dollar; end-of-period)	8,040	8,002	8,222
Real effective exchange rate (2000=100)	125.2	127.6	133.7
Nominal GDP					
In billions of kip	56,523	66,513	74,784	86,491	97,729
In millions of U.S. dollars	6,855	8,302	9,219	10,283	11,179
Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.					
1/ Public finances are on a fiscal year (October to September) while other data are on a calendar year.					
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.					