



Office Memorandum

To: Members of the Executive Board

August 1, 2013

From: The Secretary

Subject: **Lao People's Democratic Republic—Assessment Letter for the Asian Development 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 Asian Development Bank (AsDB).

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

Questions may be referred to Mr. Ahuja, APD (ext. 35464) and Mr. Bannister, WHD (ext. 35979).

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

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FO/DIS/13/119

**Lao People's Democratic Republic—Assessment Letter for the Asian Development Bank
July 31, 2013¹**

Lao P.D.R. is growing rapidly, but accommodative policies risk exacerbating external imbalances and financial sector vulnerabilities. The authorities should tighten policies to strengthen fiscal and external buffers, and pursue structural reforms to ensure that growth is more broad-based and inclusive.

1. **Growth prospects remain strong, with core consumer price inflation well-contained.** Real GDP growth, averaged 7 percent per annum over the past decade, is estimated at around 8 percent in 2012. Activities continue to be driven by hydropower and mining production, and increasingly by wholesale and retail trade and construction. Growth is expected to rise slightly to 8.3 percent in 2013 on robust domestic demand, despite a relative weakening of the external environment. Inflation has accelerated somewhat to 6.3 percent (y-o-y) in June 2013, largely due to higher non-rice food prices, and is expected at about 8 percent in 2013.
2. **External buffers should be strengthened in the context of growing external imbalances.** At around 1¼ months of imports (US\$0.7 billion), international reserves are low in comparison to regional partners.² The real effective exchange rate has appreciated by about 6½ percent in the past twelve months, partly from relative higher inflation in Lao P.D.R. Strong domestic demand and currency appreciation have put pressure on the balance of payments with non-resource import growth expected to outpace exports. The current account deficit is expected to widen to 31 percent of GDP in 2013, from 28 percent in 2012, almost twice the level of 2011. The overall balance of payments is in a small surplus in 2012, as the current account deficit is offset by strong investment inflows, which are expected to continue.
3. **Monetary policy continues to be accommodative, buoying domestic demand and non-resource imports.** Central bank net domestic assets and private sector credit both grew by 35 percent y-o-y to March 2013, continuing the rapid pace from the previous year. In addition, quasi-fiscal lending to local governments by the Bank of Lao P.D.R. (BoL) continued at a rapid pace during the first quarter of 2013, spurring domestic demand. Although official financial sector indicators do not point to imminent problems, there is a concern that rapid credit growth and appreciation in collateral value could mask underlying vulnerabilities.
4. **The fiscal deficit is expected to rise significantly in 2013.** Large increases in public sector wages and compensation are expected to lead to a deterioration of the fiscal deficit from around 2½ percent of GDP in 2012 to 4½ percent of GDP in 2013. Wages and compensation are expected to rise to slightly over half of all recurrent expenditure going forward. This has the potential to limit the scope for fiscal policy to respond to future shocks and to 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

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

² The authorities calculate reserves coverage on the basis of officially reported imports, which are under-measured relative to third-country data which the IMF uses.

strong import growth. The deterioration of the fiscal stance in 2013 makes fiscal consolidation more pressing over the medium term.

5. **The 2012 debt sustainability analysis assessed the risk of debt distress as moderate.** Nevertheless, the debt ratio (at 52 percent of GDP at end-2012) is relatively high and a large proportion (over 80 percent) is in foreign currency.

6. **Macroeconomic policies should be tightened in the near term to strengthen external and fiscal buffers.** A tightening of monetary policy would temper domestic demand and contain inflation expectations, which would support a relatively stable exchange rate and the further accumulation of international reserves. This is particularly important in the context of a large increase in the public wage bill and a consequent deterioration in the fiscal balance which could further erode competitiveness and exports. Quasi-fiscal lending to local governments by the BoL should also be reduced to avoid overheating, and the central bank should continue to unwind these operations. Fiscal policy should be calibrated to put the deficit on a declining path and gradually reduce the debt ratio. These policies would reduce the current account deficit to more sustainable levels. Strengthening banking supervision by shifting from a compliance-based approach to one that adequately addresses risks is also critical to ensuring healthy credit growth.

7. **The baseline medium-term outlook for growth remains favorable, but it should be more inclusive.** Reforms should aim at achieving more broad-based growth by enhancing competitiveness in the non-resource sector. For this, it will be necessary to accelerate Public Financial Management 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, education, and infrastructure will also support the promotion of inclusive growth.

8. **IMF Relations:** The 2012 Article IV consultation was concluded by the IMF's Executive Board on August 31, 2012. The 2013 Article IV consultation mission is scheduled for September, 2013. The IMF is 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	7.9	8.3	7.8
CPI (annual average)	6.0	7.6	4.3	7.6	9.6
CPI (end year)	5.8	7.7	4.7	8.0	10.1
Public finances (in percent of GDP)					
Revenue	18.3	18.3	19.6	20.3	19.8
<i>Of which</i> : Resources	2.6	3.3	3.9	4.0	3.4
<i>Of which</i> : Mining	1.8	2.5	3.2	3.2	2.5
<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	2.1	1.8	1.7
Expenditure	23.0	20.4	22.2	24.8	24.5
Expense	12.5	12.1	12.8	16.1	16.4
Net acquisition of nonfinancial assets 2/	10.6	8.3	9.4	8.8	8.1
Net lending/borrowing	-4.7	-2.1	-2.6	-4.5	-4.7
Nonmining balance 3/	-6.5	-4.5	-5.8	-7.6	-7.2
Money and credit (annual percent change)					
Reserve money	48.6	16.2	27.2	20.8	21.7
Broad money	39.5	28.7	31.0	25.9	24.1
Bank credit to the economy 4/	48.4	45.8	26.6	29.7	19.9
Bank credit to the private sector	48.4	39.3	35.1	29.0	20.0
Balance of payments					
Exports (in millions of U.S. dollars)	2,196	3,120	3,323	3,356	3,553
In percent change	44.4	42.1	6.5	1.0	5.9
Imports (in millions of U.S. dollars)	3,574	4,635	6,355	7,011	7,323
In percent change	23.6	29.7	37.1	10.3	4.5
Current account balance (in millions of U.S. dollars)	-1,251	-1,262	-2,602	-3,110	-3,206
In percent of GDP	-18.2	-15.5	-28.4	-30.8	-29.0
Gross official reserves (in millions of U.S. dollars)	728	677	740	751	848
In months of prospective goods and services imports	1.8	1.2	1.2	1.2	1.3
(Excluding imports associated with large resource projects)	2.6	1.7	1.7	1.7	1.8
External public debt and debt service					
External public debt					
In millions of U.S. dollars	3,539	3,685	3,993	4,383	4,766
In percent of GDP	50.3	45.1	43.6	44.7	43.2
External public debt service					
In percent of exports	4.4	2.7	4.1	4.2	4.4
Exchange rate					
Official exchange rate (kip per U.S. dollar; end-of-period)	8,040	8,002	7,992
Real effective exchange rate (2000=100)	125.2	127.6	133.7
Nominal GDP					
In billions of kip	56,523	65,398	73,269	83,301	97,598
In millions of U.S. dollars	6,855	8,162	9,171	10,101	11,039
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.					