May 21, 2020
Approval: 5/29/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/71-1

10:00 a.m., August 2, 2019

1. Lao People's Democratic Republic—2019 Article IV Consultation

Documents: SM/19/194 and Correction 1; and Supplement 1; and Supplement 2; and Supplement 2, Correction 1

Staff: Kvintradze, APD; Sun, SPR

Length: 40 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	**Alternate Executive Directors**
	M. Ismail (AE), Temporary
	O. Diakite (AF), Temporary
	R. Morales (AG), Temporary
	J. Shin (AP), Temporary
	F. Antunes (BR), Temporary
	P. Sun (CC)
	M. Mulas (CE), Temporary
L. Levonian (CO)	
	M. Mehmedi (EC), Temporary
	A. Castets (FF)
	K. Merk (GR)
	B.Singh (IN), Temporary
	L. Cerami (IT), Temporary
	Y. Saito (JA)
	M. Daïri (MD)
	F. Al-Kohlany (MI), Temporary
	S. Harutyunyan (NE), Temporary
	J. Sigurgeirsson (NO)
	L. Palei (RU)
	R. Alkhareif (SA)
A. Mahasandana (ST)	
	P. Trabinski (SZ)
	J. Freeman (UK), Temporary
	D. Crane (US), Temporary

H. Al-Atrash, Acting Secretary
H. Malothra, Summing Up Officer
A. Lalor, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: N. Adachi, J. De, E. Kvintradze, A. Mourmouras, C. Rhee. Legal Department: J. Swanepoel. Strategy, Policy, and Review Department: V. Klyuev, Y. Sun. World Bank Group: D. Mishra. Senior Advisors to Executive Directors: Z. Abenoja (ST), Z.Mahyuddin (ST), S. Potapov (RU), J.Weil (CO). Advisors to Executive Directors: S. Belhaj (MD), M. Bernatavicius (NO), S. Buetzer (GR), S. Chea (ST), K. Kuretani (JA),

U. Latu (ST), R. Pandit (ST), A. Srisongkram (ST), D. Susiandri (ST), S. Yoe (ST), S. Alavi (MD), K. Lok (CC), A. Sode (FF).

1. LAO PEOPLE'S DEMOCRATIC REPUBLIC—2019 ARTICLE IV CONSULTATION

Ms. Mahasandana and Mr. Abenoja submitted the following statement:

Our Lao authorities would like to express their gratitude to the mission team for the comprehensive assessment of the economy and constructive policy dialogue during the Article IV consultation. They are highly appreciative of staff’s careful analysis of the Lao economic structure and the consideration of the rationale behind the policy thrusts. The authorities generally agree with staff’s assessment of the outlook and risks as well as the policy priorities. They will carefully consider the recommendations when formulating policies and pursuing reforms to achieve a more sustainable, broad-based and inclusive economic growth.

Introduction

The Lao economy continued to expand in 2018, albeit slower compared to the previous year, with inflation remaining low. Although total public debt remains high, the fiscal deficit has narrowed to 4.4 percent of GDP. Credit growth has moderated due in part to the slowdown in the economy and fiscal consolidation. Current account deficit remained large, as the increase in exports, particularly from the hydropower sector, was offset by imports related to major infrastructure projects and recovery efforts from natural disaster. As such, the international reserves declined slightly to about 3.2 months of non-FDI imports.[1] Moving forward, economic expansion is expected to remain robust with contributions from investments, construction, hydropower exports and tourism. Nonetheless, challenges remain including uncertainty in the global economic environment, slowdown in major partner countries, impact of possible natural disasters and the need to maintain prudence in macroeconomic management while pursuing economic transformation. However, on-going integration within the Asian region as well as the global economy will bring greater opportunities for investments, trade and tourism. At the same time, the authorities are committed to carry on the implementation of reforms that will enhance the resilience of the economy against possible shocks.

Looking ahead, the authorities recognize the importance of maintaining policy discipline and the urgency of further deepening reforms.

[1] The authorities assess the reserve cover using import levels adjusted for FDI-related imports given that most of the FDI-related projects use their own funding which are unrelated to the international reserves at the central bank.

They are strongly committed to implementing sound, responsive and prudent macroeconomic policies and to sustain the reform momentum that has been built up to reduce macroeconomic vulnerabilities, address structural weaknesses, enhance human development and promote inclusive growth. Diversification of the economy supported by the achievement of the SDGs and improvement in competitiveness is explicitly incorporated in the government's 5-year plan and important progress has been made across various fronts. In fact, Lao PDR passed the first step towards graduation from Least Developed Country (LDC) status as assessed by the UN Committee for Development Policy in March 2018.[2] The authorities are determined to complete the process and aim to achieve formal graduation from LDC status in 2024.

Economic developments and outlook: Sustaining growth while reducing vulnerabilities

The overall economic performance remains robust with imbalances beginning to narrow. Economic growth continues to be strong at 6.3 percent in 2018 but moderated due to the slowdown in trading partners, flood-related disasters, decline in mining production and re-assessment of some government projects. The expansion can be attributed mostly to the growth in wholesale and retail trade, construction, real estate and tourism. Inflation rose to an average of 2.0 percent in 2018 from about 0.8 percent a year earlier, as flooding led to higher prices on agricultural products along with the rise in international oil prices. On the fiscal sector, the fiscal deficit narrowed to 4.4 percent of GDP from 5.5 percent in 2017, helped by the optimization of public spending. Public debt as percent of GDP remains elevated and the risk of external debt distress is high. Although most of the public external debt is on concessional and semi-concessional terms, the composition has also been gradually shifting due to recent bond issuances in the Thai capital market. As such, the authorities are placing greater focus on managing the potential risks of debt distress given the high level of public debt and its composition. In terms of money supply, broad money increased at a slower pace of 8.4 percent. Credit growth to the private sector decelerated to 4.7 percent in 2018, partly due to the moderation in economic activity after the natural disaster and the fiscal tightening. The banking system remains strong with total assets growing by 6.5 percent and deposits by 8.3 percent in 2018. On the external front, the current account deficit widened slightly and remains

[2] The Committee for Development Policy, which is a subsidiary of the UN Economics and Social Council, assessed the Lao PDR to have met the eligibility for LDC graduation for the first time in 2018. Based on the graduation process, if Lao PDR continuous to demonstrate development gains and fulfills the criteria again in 2021, it will formally graduate from LDC status in 2024.

elevated but is still on downtrend since 2015 at about 8.0 percent of GDP as of end-2018. At the same time, international reserves reached 3.2 months of non-FDI related imports.

While the outlook remains generally favorable, authorities are cognizant of the policy imperatives, including gradually rebuilding fiscal and external buffers as well as reducing vulnerabilities. For 2019, GDP is projected to accelerate to 6.7 percent supported by electricity generation, construction and tourism. In particular, hydroelectricity production is expected to increase with the completion of several hydropower plants. Infrastructure projects, including the Vientiane-Vangvieng expressway and the on-going Lao-China railway, are also expected to spur construction activities. The services sector will likewise benefit from the launching of the Visit Laos-China Year 2019. Moreover, the government has embarked on an 8-point program which is expected to continue to stimulate domestic production and services.[3] Meanwhile, inflation remains manageable at around 3.0 percent. Fiscal consolidation will be pursued alongside reforms to facilitate a steady decline in the fiscal deficit to 2.0 percent of GDP by 2025. Overall, broad macroeconomic stability will be preserved. The authorities will continue to focus on managing pressures on public debt and on steadily building fiscal and external buffers.

Sustaining fiscal consolidation and reforms towards a sustainable public debt path

A two-pronged approach of improving revenues and optimizing expenditures has been adopted to complement efforts in improving overall fiscal debt management. Given risks from an elevated public debt ratio, the authorities recognize the need to heighten fiscal consolidation efforts and to improve institutional capacity to further invigorate on-going fiscal reform initiatives. This commitment is reflected in the significant reduction of the fiscal deficit in 2018 despite the difficulties during the year. The authorities will continue to strongly pursue public resource management and tax reforms as well as spending efficiency measures to reduce debt burden, build fiscal space and finance the social development and infrastructure needs.

---

[3] Prime Minister Order No. 12/PM refers to the implementation of eight economic stimulus measures covering the following: effective management of inflation; enhancement of monetary policies; improvement of business climate and ease of doing business; enhancement of revenue collection efficiency and budget expenditure management; promotion of SMEs and domestic production; improvement of investment structure including composition of investment; land management and land income collection; strict inspection and monitoring of compliance to laws and regulations.

The authorities are determined to enhance revenue mobilization through improvements in tax administration and tax policy reforms. The authorities have embarked on using ICT to improve tax administration, specifically with the adoption of electronic tax payments through the banking system for road taxes. This has resulted in about six-fold increase in road tax receipts. The same electronic payment strategy is now being rolled out for land, VAT and income taxes. Furthermore, the authorities introduced the Tax Revenue Information System (TaxRIS) to enable a systematic monitoring of revenue collection performance and to facilitate the management of the tax base. An improvement of the organizational structure at the central and district levels is being implemented, complemented by systematic trainings for tax officials to upgrade their management and technical capacity. To widen the tax base, an enterprise survey is being completed and a nationwide-linked revenue database is being strengthened. At the same time, tax laws are being reviewed to address possible revenue leakages. Furthermore, the Customs Department is closely monitoring the imports of key commodities. Finally, tax exemptions will be strictly implemented based on the list of items under the Law on Investment Promotion. The above actions are complemented by a Medium-Term Revenue Strategy that is being developed with FAD to lay out a comprehensive, coordinated and well-sequenced reform approach underpinning the authorities’ strong commitment to improve revenue mobilization.

The authorities are firmly committed to rationalize and improve the efficiency of government expenditures. The government has agreed on a comprehensive multi-phase Public Financial Management strategy to be supported by development partners. The government has been reducing civil recruitment to contain the public wage bill. Planned capital spending has been reprioritized to support post-disaster reconstruction efforts after the 2018 natural disaster. New investment projects have been temporarily suspended and some on-going projects are being assessed for their impact and rates of return so as to better prioritize capital spending. Efforts are also taken to centralize and streamline budget management so as to improve the efficiency and transparency of the budget process.

The authorities are focused on strengthening fiscal governance and upgrading debt management capacity to complement fiscal consolidation efforts in reducing public debt and building space for developmental expenditures. While public debt is high and mostly external, more than half of the external debt is on concessional and semi-concessional terms. Moreover, a non-trivial share of external debt is supported by electricity export earnings from hydropower projects with underlying long-term power purchase agreements. This important feature help to mitigate risks and maintain debt indicators within sustainable levels. Moreover, the announced fiscal consolidation measures and the adoption of a temporary moratorium on new projects are expected to further improve debt carrying capacity. Nonetheless, the authorities will continue to pursue initiatives to further improve debt management. The 2018 Public Debt Management Law enhances a rule-based regime for contracting and guaranteeing public debt. Fiscal governance is strengthened as it consolidates the oversight responsibility of public debt within the Ministry of Finance, thus facilitating the formulation of a well-informed medium-term debt management strategy. Moreover, debt sustainability efforts will also benefit from careful targeting of infrastructure projects that yields high social and growth returns with financing coming from concessional loans.

Pursuing manageable inflation and strengthening the external sector

The Bank of Lao P.D.R (BOL) will continue to conduct prudent monetary policy and adopt a managed floating exchange rate regime, with the exchange rate fluctuating within a band, aimed at maintaining low inflation and promoting a stable macroeconomic environment to support sustainable economic growth. Given the manageable inflation last year, the policy rate and reserve requirement ratios were maintained in 2018. The monetary governance framework is being modernized. New legislations on the BOL, Commercial Bank and the Payment Systems were passed last year with the implementing regulations and guidance currently being rolled out. The authorities are supportive of market-based interest rates and has removed the temporary measure that was deployed to address the surge in lending rates arising from competition among banks for deposits. The authorities continue to implement the package of measures to promote the greater use of the local currency and facilitate de-dollarization including a Lao Kip promotional campaign and strict enforcement of legislation on domestic transactions to be based in Lao Kip. Moreover, the manageable inflation rate and stable exchange rate together with improvements in mobile banking services are expected to encourage the greater use of the Lao Kip.

The managed floating exchange rate regime has served as an effective anchor for inflation. The authorities see the merit of gradually introducing greater exchange rate flexibility over the medium term when preconditions are in place to facilitate the transition. In particular, efforts to deepen the interbank market as well as to develop the domestic debt market and foreign exchange derivative market would facilitate a more flexible exchange rate system. These are on-going efforts and the authorities will carefully consider staff's various recommendations to further develop the debt securities market and monetary operations, including improving liquidity forecasting.

While the authorities view the level of international reserves as broadly adequate, after taking into consideration that parts of the imports are usually funded from accounts abroad of FDI-related projects, they recognize the benefits of increasing the gross international reserves to further build external resilience. It may be noted that large foreign direct investments have generally been maintaining their foreign exchange earnings abroad. Over the medium to long term, the increase in export earnings as economic diversification advance and the rise in tourism receipts can help further fortify the international reserve position.

Strengthening and modernizing the financial system

The authorities are focusing on enhancing the resilience of the banking sector, including through the upgrading of the regulatory and supervisory framework. The authorities view the strengthening of the financial system as a continuing and crucial process amid increasing integration with the global economy. Relevant laws and regulations have been amended to be in line with international best practices. In particular, the Commercial Bank Law contains relevant provisions for crisis management and bank resolution. To fully implement the provisions of the law, the BOL is carefully drafting prompt corrective action, crisis management and resolution framework to improve its regulation under the Commercial Bank Law. Also, to supervise the domestic payments and settlement system, the BOL established the Payment and Settlement Supervision Department and issued the Payments System Law.

Much progress has been achieved in strengthening risk-based supervision in line with the Fund's advice and technical assistance. The BOL has formulated a risk-based supervision manual to help its Supervision Department in supervising and monitoring commercial banks in a forward-looking manner. The manual is currently being pilot tested in the BOL's analysis and supervision activities. Bank supervision is also being improved towards Basel II while an accounting system in line with IFRS is being developed in order to further build market confidence and attract domestic and foreign investments. Recently, BOL has revised the regulation on FX lending to allow commercial banks and branches of foreign commercial banks to provide loans in FX for both customers with or without FX income. However, the use of the foreign exchange proceeds for the payment of their foreign exchange obligations or foreign exchange transactions should be in line with the Law on the Management of Foreign

Currency to help manage fx lending risks. The state-owned banks are being restructured which will help bring down the level of non-performing loans. Moreover, the government is evaluating past public projects to identify payment obligations and issuing bonds to commercial banks in exchange of overdue loans related for these projects. Finally, financial soundness indicators have been developed and regularly disseminated to better evaluate developments in the banking system.

The BOL will continue to engage international partners actively. In particular, the authorities underscore the importance of deepening cooperation with the region and the international community to exchange lessons and experiences, and to seek technical assistance to develop a sound and modern financial system.

Embracing the transformation to a more diversified, competitive and inclusive economy

The authorities are committed to continue the gradual process of diversifying the resource-based economy towards a broad-based structure with contributions from the agriculture, services and manufacturing sectors. To encourage greater investments, the authorities will continue to improve the legal framework, create a level playing field and address bottlenecks to doing business. Programs to improve education and health are being supported to enhance progress in poverty reduction, raise productivity and help achieve key SDGs. The importance of gender inequality is being assessed as part of the development process and promoting inclusive growth.

Public infrastructure is crucial in the transformation from a land-locked to a land-linked economy. Investments in public infrastructure such as road, bridges, railways and power transmission lines would serve to invigorate investments, raise exports and promote developments in the countryside.

The development of the SME sector, which covers 98 percent of all enterprises, is a priority of the authorities to promote broad-based growth. The Ministry of Industry and Commerce is formulating an SME development plan and provides advisory services to SMEs. Meanwhile, the BOL is drafting a credit policy for SMEs, seeking funding resources to establish an SME fund and continuing to improve the payment system to facilitate growth of SMEs.

Elements of governance are being strengthened as part of raising overall efficiency and providing an enabling environment for investments.

The Public Procurement Law and the Law on Public Investment promote a more transparent and rules-based institutional framework for public spending and investments. Important advances have been made in implementing the legislation on AML/CFT. The National Risk Assessment was completed in 2017-18 to identify priority areas for improvement. The authorities have in place an interagency coordination mechanism and MoUs for data gathering to support preparations for the full assessment against the Financial Action Task Force (FATF) standard to be undertaken in 2020.

The authorities also recognize the importance of continuously improving the quality and availability of economic data to guide policy decision making and transparency. In this regard, the authorities are appreciative of the Fund assistance which contributed to better quality of data on national income accounts and fiscal, monetary and financial sectors that are now being compiled and released by government agencies.

Concluding remarks: Staying the course towards durable and inclusive growth

The authorities are committed to pursue prudent macroeconomic policies and to carry out the reform agenda to build the foundations for a durable, sustainable and inclusive economic growth. The authorities recognize the importance of addressing the risks arising from high level of public debt and a wide current account deficit. As such they are determined to complete the implementation of recent legislations and to follow through with reforms along the lines recommended by staff. They are focused on fiscal consolidation and on continuing to improve debt management to bring public finances firmly on a sustainable path. Monetary and exchange rate policies are grounded in providing a stable macroeconomic environment while financial policy is aimed at strengthening and modernizing the financial sector. The authorities have set an ambitious reform agenda to diversify the economy and lift living standards. They are determined to pursue a gradual, well-considered and deliberate process for the transformation of the economy while preserving social cohesion. Governance and transparency practices are being improved. In fact, the authorities have approved the publication of the IMF press release after the Article IV mission, a practice that was not done in recent years. In this regard, they are grateful to Fund staff for the helpful technical assistance and the invaluable policy advice. The authorities look forward to continuing the close and productive engagement with the Fund.

Mr. Merk and Mr. Buetzer submitted the following statement:

We thank staff for its informative set of reports and broadly concur with its assessment. We also thank Ms. Mahasandana and Mr. Abenoja for their helpful buff statement.

Throughout the last decade, Lao P.D.R. has made solid progress with regard to economic and SDG indicators. Nonetheless, there is still a long way to go for the country and large obstacles remain. The tragic floods last year have underlined the vulnerability of the country to natural disaster shocks. We concur with staff that creating the fiscal space, inter alia to build resilience against shocks from natural disasters, should be a priority going forward.

Against the backdrop of elevated public and publicly guaranteed external debt, the risk of debt distress is high and debt carrying capacity has deteriorated. These high risks are only somewhat mitigated by large long-term intergovernmental power purchase agreements. We concur with staff that the authorities should improve the efficiency of public investment and accelerate PFM and tax policy reforms, in particular VAT and corporate tax reform, with the goal of increasing revenues and transparency. We take positive note of the authorities' determination in this regard as expressed in the buff statement. Moreover, exemptions and discretion for bargaining should be reduced, which would also contribute to lowering vulnerabilities to corruption. Generally speaking, the authorities should strive to strengthen institutional frameworks and governance as suggested by staff, not least to improve the business climate and enhance the effectiveness of the AML/CFT regime.

We largely share staff's assessment of monetary policy. We agree with staff that a widening of the FX trading band might be an adequate medium-term policy to increase exchange rate flexibility, which would also facilitate building more adequate reserve buffers to reduce the country's susceptibility to external shocks.

We note that - except for a few state-owned banks - risks in the financial sector, seem contained, even though a comprehensive assessment is hampered by data availability constraints. Against this backdrop, we encourage the authorities to make steadfast progress in implementing IFRS accounting and reporting standards and enhancing risk-based supervision.

We support staff's view that growth should be rebalanced away from an overly resource-intensive model towards more investments in human capital and infrastructure. In this context, limited access to finance of SMEs poses an obstacle to economic diversification that should be addressed by simplifying the regulatory environment for SMEs as well as offering tailored training programs to small entrepreneurs, especially women. We emphasize that infrastructure investments should particularly focus on infrastructure complementing recent and current large-scale projects such as the Lao-China Railway by facilitating its connection and integration into regional and local transport and value chains.

Lastly, we echo staff's call to make fiscal accounts more transparent and bring data more in line with international standards in order to improve policymaking and credibility.

In this context, we strongly encourage the authorities to consent to the publication of this report. A timely release of the report would help the effectiveness of Fund surveillance. That being said, we welcome that the authorities have approved the publication of the IMF press release for the first time in many years as a first step.

Ms. Mannathoko and Mr. Tivane submitted the following statement:

As one of the fastest growing economies in the East Asia and Pacific region over the past decade, Lao PDR's performance record is commendable, with expenditure policies having helped to reduce poverty and improve public welfare. Nevertheless, the country's vulnerability to natural disasters presents significant risks. Since the last board discussion, growth has decelerated in the wake of a 2018 climate shock, with severe flooding impacting agricultural production and infrastructure. The current account deficit has also widened as a share of GDP, as disaster related imports added to ongoing mega-project imports. We therefore empathize with authorities as they face these challenges while seeking to improve the welfare of the Lao people. We wish to encourage them to continue to pursue the SDGs, seek new channels for growth and build more resilient infrastructure while preserving macroeconomic stability. We also wish to highlight the importance of rebuilding buffers as soon as possible after they are drawn down. buffers are needed on an ongoing basis to help stabilize the economy, given the recurring nature of climate shocks and the possibility of declines in external demand. We welcome the authorities' stated commitment to the reform agenda as highlighted in the buff statement by Ms. Mahasandana and Mr. Abenoja and broadly concur with staff's appraisal. We have a few additional comments.

Fiscal Policy: We commend the authorities on the reduction in the fiscal deficit in 2018, despite extremely challenging conditions. Going forward, we encourage an analytically-based fiscal consolidation instrument mix. We note actions taken to improve domestic revenue collection, contain spending and strengthen public debt management. We also note government efforts to strengthen revenue administration, including the introduction of electronic tax payments. And we commend authorities on the completion of the medium-term revenue strategy and encourage its timely approval and implementation. That said, we encourage moving toward a rules-based tax incentive system, given the substantial inefficiency and leakage often associated with excessive discretion. Furthermore, like staff, we would urge authorities to reconsider the current approach to fiscal consolidation via capital expenditure compression. We wish to highlight the importance of ensuring that the overall fiscal instrument mix chosen to effect consolidation takes into account the different elasticities of different revenue mobilization and expenditure choices, to ensure that the net effect is not regressive. If this analysis has not already been done for Lao, we wonder if assistance is available from the Fund or other development partners to help with country-specific analysis in this area? Staff comments are welcome.

Debt performance: We welcome the adoption of a holistic strategy to improve structural resilience in Lao taking into account debt sustainability risks. We also note that alongside the impacts of climate shocks, weak export performance and the significant depreciation of the currency worsen Lao’s debt indicators in the short-term. However, often times currency depreciation would be expected to boost export performance in the medium to long term, helping to improve debt carrying capacity and debt service indicators. Could staff comment on the relative magnitudes of these effects in Lao and elaborate on pertinent advice to the authorities?

Monetary and financial policies: The progress made in clearing the stock of payment arrears for past infrastructure projects is a welcome development. We note that the resolution of the associated NPLs will help to strengthen bank balance sheets, supporting credit growth from 2019 onwards; and urge the authorities to put systems in place now (including commitment controls and quarterly spending ceilings under the new PFM framework) that will guard against the re-emergence of these arrears going forward. We also encourage the authorities as they complete the restructuring of some of the state-owned banks, noting their observation that this will also help to bring down the level of NPLs. We note the adoption in 2018, of the new legal framework for modernization of monetary governance and encourage its timely implementation. Beyond this, we urge ongoing timely implementation of remaining risk-based supervision measures, transitioning to IFRS accounting and reporting standards, and keeping to the timeline for transitioning to the Basel II framework. We also emphasize the importance of a monetary and exchange rate strategy that supports the building up of foreign reserve buffers.

External sector: Despite higher metal prices for mineral exports, and increased electricity generation, there doesn't seem to have been much increase in these exports, with their share in GDP declining between 2017 and 2018 and projected to decline further going forward. Presumably this decline reflects mining sector performance? Could staff elaborate on the reasons behind the unexpectedly weak mining export trend?

Structural reforms: We urge authorities to focus on the implementation of structural reforms identified by staff as critical to the diversification and growth needed for Lao's progression to middle income status. In this regard, we welcome the 8th National Socio-Economic Development Plan (2016-2020) and encourage attention to the use of efficient and effective systems in its implementation.

With these comments, we wish the Lao authorities ongoing success and progress with reforms.

Mr. Fanizza and Ms. Cerami submitted the following statement:

We thank staff for their comprehensive report and Ms. Mahasandana and Mr. Abenoja for their helpful buff statement. We welcome Lao's continued robust growth and low inflation despite the recent natural disasters. Nonetheless, the country remains vulnerable to downside external and climate-related risks due to structural weaknesses. Therefore, we welcome the authorities' commitment to continue to strengthen macroeconomic and financial resilience and to promote a more sustainable and inclusive growth. We agree with staff's appraisal and support the ongoing Fund's Capacity Development to Lao P.D.R.

The outlook for growth remains favorable, but high public and external debt require prudent fiscal policy. Fiscal consolidation should continue through improving public financial management and tax revenue mobilization. The authorities have already taken important steps, including: the moratorium on new projects, the adoption of the new public procurement law and of the public debt management law, the completion of the Public Expenditure and Financial Accountability assessment, and the development of a Medium-Term Revenue Strategy with the support of the Fund. Building on these actions, a thorough review of spending and a well-designed tax reform will help generating resources for developing physical and human capital and strengthening resilience to natural disasters, while ensuring that public debt remains on a steady downward path.

Building international reserves and diversifying the economy will be key to restoring competitiveness and external balance. The current account deficit is large while the external debt is high, and the reserve coverage is assessed as weak. Greater exchange rate flexibility and improved liquidity forecasting will help the necessary build-up of international reserves in the short-term. Going forward the implementation of the new legal framework for the central bank, payment systems and the banking sector will be of paramount importance. In this context, consideration should be given to measures to develop the foreign exchange market and reviewing the regulations on foreign currency lending and the foreign exchange reserve requirements.

Ensuring public debt sustainability remains a key priority. We are concerned that the debt carrying capacity has deteriorated. We take note of several mitigating factors such as the growing energy exports backed by long-term intergovernmental power purchase agreements, the large share of concessional external debt, the preserved market access, and the declining stock of expenditure arrears. However, the country remains vulnerable to shocks to exports, currency depreciation, and contingent liabilities from public-private partnerships (PPPs) and the banking system. Therefore, we encourage the authorities to review the institutional framework for PPPs and consider a Public Investment Management Assessment (PIMA), as well as to address data gaps, which prevent a full assessment of banks' non-performing loans and potential capital shortfalls.

Economic and export diversification should be accelerated. Lao P.D.R. has successfully transitioned from a mining to a renewable energy and export driven economy. However, the capital-intensive energy sector has not spurred growth to the rest of the economy. Staff report suggests several actions to promote a more broad-based, sustainable and inclusive growth, particularly in the areas of human capital development, including greater participation of women in the formal economy, business and trade regulations, access to finance, transparency, corruption, and financial integrity. The overarching objective is to develop a well-diversified private-sector driven economy and broaden the export base to reduce external vulnerabilities. The geographic diversification of energy exports pursued by the authorities is a positive step forward. We welcome the removal of the interest rate cap and look forward to the pending regulatory guidance. We encourage the authorities to address remaining weaknesses in the AML/CFT framework in preparation of the next full FAFT assessment scheduled for 2020.

Ms. Pollard and Ms. Crane submitted the following statement:

We thank staff for the informative papers including a number of interesting appendices and Ms. Mahasandana and Mr. Abenoja for the helpful buff statement. The Lao economy has high potential, but also faces significant risks while economic buffers are thin. Strengthening fiscal and debt management and building foreign exchange reserves are key priorities. We also encourage the authorities to narrow the scope for corruption by improving fiscal, monetary and financial sector governance and transparency. We agree with staff that the authorities will need to strengthen their attention to implementation and effectiveness of AML/CFT measures, ahead of the 2020 FATF review. We concur with the thrust of the staff appraisal and would like to highlight several points.

Fiscal Policy. Making fiscal consolidation more growth friendly should be a priority. We appreciate the authorities' efforts to reach a 2 percent of GDP fiscal deficit by 2025, but caution against over-reliance on expenditure compression. Improving the quality and efficiency of spending is important, but Lao PDR also has significant room to boost revenue through base-broadening by reducing tax exemptions and adopting a rules-based tax incentives system. We look forward to the authorities' development and implementation of a Medium-term Revenue Strategy.

Debt Sustainability. We encourage the authorities to focus on reducing risks to debt sustainability. Lao PDR's low debt carrying capacity under the new LIC-DSF highlights the importance of improving fiscal and debt management to restore greater capacity to take on debt. The suspension of new investment projects combined with a more rigorous analysis and prioritization process and a new Public Procurement Law are steps in the right direction. The DSA quantifies the very large contingent liabilities created by PPPs, and we echo staff in encouraging the authorities to strengthen the PPP framework and take into account the direct and indirect fiscal risks of PPPs. We took note of staff's customized scenario of power sector related debt in the DSA. While this type of analysis can complement the DSA by demonstrating certain strengths in Lao PDR's debt structure, we would not want this analysis to send the signal that certain debts ought to be excluded from the DSA analysis.

Data and Statistics. We welcome the significant strides forward on data and statistics, including Lao PDR joining e-GDDS, but there is a large remaining agenda. Debt data recording is an area that requires ongoing attention, and we hope that the new Public Debt Management Law will drive further progress. Can staff comment on whether there are any significant remaining debt data gaps? We thank staff for the information regarding shortcomings regarding Article VIII Section 5 obligations with respect to debt stocks and International Investment Position (IIP) data, noted in the Information Annex. We took note of the new IIP enterprise surveys, as an important step forward. Can staff comment on plans to provide support for Lao PDR to overcome capacity constraints related to meeting its obligations on provision of data to the Fund over a realistic timeframe?

Publication. We encourage the authorities to publish this Article IV report. Are staff aware of any particular concerns holding the authorities back from agreeing to publish?

Mr. Benk and Mr. Mehmedi submitted the following statement:

We thank staff for the well-written and informative reports and Ms. Mahasandana and Mr. Abenoja for their in-depth buff statement. While growth in Lao PDR slowed down recently due to natural disasters, it remains one of the highest among its peers and medium-term economic prospects are favorable. Nonetheless, macro-vulnerabilities stemming from the twin deficits, high public debt, elevated dollarization, low reserves, weak external sector, and high poverty and inequality rates could jeopardize the recent economic success. Hence, a time-bound comprehensive reform program aimed at sustaining the growth momentum is needed, while also reducing fiscal risks, increasing external competitiveness, and rebalancing the economy towards a more diversified and broad-based growth to improve social outcomes. We broadly agree with the thrust of staff appraisal and would like to provide the following comments for emphasis.

Putting debt on a downward trajectory will entail implementing qualitative fiscal consolidation measures aimed at broadening the tax base, reprioritizing expenditures, and implementing structural fiscal reforms. While we welcome that the pace of fiscal consolidation has accelerated recently, the quality of the consolidation remains low due to underperforming revenues and compression of capital spending. Against this backdrop, rebalancing the composition of fiscal consolidation from expenditure compression towards domestic revenue mobilization will be essential to achieve the authorities' target of reducing public debt to below 50 percent of GDP and aligning spending priorities with social development goals. Considering that up to 80 percent of the profit tax base is exempted, it will be necessary to review tax exemptions and enhance the transparency of the tax system, including by implementing a rules-based system which eliminates discretion. The authorities should draw their policy actions from the recently completed Public Expenditure and Financial Accountability (PEFA) assessment. We welcome the new Public Debt Management Law which enhances the process of contracting and guaranteeing public debt but note that data shortcomings, coverage of debt, and sustainable lending practices and transparency, including those related to the Belt and Road initiative projects, should be further improved. Staff's comments on the authorities' envisaged timeline to develop a medium-term debt strategy are welcome.

Greater exchange rate flexibility should be considered to aid external adjustment and build up reserves. Against the backdrop of an overvalued kip, there is a need to allow a gradual exchange rate movement to support competitiveness and help accumulate reserves. To this avail, strengthening the monetary policy regime, including by modernizing the monetary policy governance, deepening the interbank market, developing the debt securities market, and enhancing the BOL's liquidity forecast will be essential. Staff's comments on whether the BOL is considering widening the FX trading band are welcome.

Strengthening the financial supervisory framework, reducing dollarization, and addressing AML/CFT risks would enhance financial sector resilience. We welcome the approval of the new Commercial Bank Law and the recent removal of the caps on banks' deposit and lending rates which were introduced in 2015. However, going forward, further efforts are needed to fully transition to Basel II and moving to a risk-based supervision, which in turn will require the steadfast implementation of the risk-based supervision manual. To increase access to finance, the authorities should address structural impediments in the banking sector to help lower lending rates and improve financial intermediation while also reforming the state-owned banks. We look forward to next year's full assessment against the Financial Action Task Force (FATF) standard and would welcome staff's assessment on the shortcomings on the effectiveness of the current AML/CFT regime.

Rebalancing the economy towards a more diversified and broad-based growth is vital to achieve robust job growth and reduce inequality. We note that the robust growth achieved in recent years has come at the expense of increased inequality and deforestation. It is therefore advisable to reconsider the capital and natural resource-intensive growth model and implement a comprehensive structural reform agenda which aims at promoting economic diversification. Enhancing the business environment, investing in human capital, tackling the widespread informality, and reducing regional and gender disparities will be conducive to that end.

Mr. Saito and Mr. Kuretani submitted the following statement:

We thank staff for the comprehensive reports and Ms. Mahasandana and Mr. Abenoja for their informative statement. Lao P.D.R. has maintained a strong economic growth in 2018, while it has suffered from natural disasters, such as heavy rainfalls and tragic collapse of Xe-Pian Xe-Namnoy dam. It is encouraging that Lao P.D.R. is solidifying its progress towards graduating from the Least Developed Country (LDC). However, the country faces multiple challenges including high public debt, large current account deficit, and low international reserves. As we broadly concur with the thrust of the staff appraisal, we would like to limit our comments to the following points:

Fiscal Policy

Faster fiscal consolidation with revenue generation and enhanced fiscal governance will support reducing the public debt and creating fiscal space. We welcome that the authorities have suspended new investment projects and taken stock of all existing projects with the view to re-prioritizing capital investment to address further infrastructure repair needs. We also welcome that the authorities have developed a Medium-Term Revenue Strategy and plan to undertake a comprehensive review of tax incentives with a view of moving to a rule-based system of granting tax incentives. We encourage the authorities to implement steadfastly the revenue reforms to generate more space for spending on social development.

Debt Management

Lao P.D.R. needs to develop a strong debt management framework. We are concerned that the DSA assesses Lao P.D.R.'s risk of external and overall debt distress as high and the debt carrying capacity classification has deteriorated compared to the previous DSA. In this regard, we welcome that the new Public Debt Management Law set a more rules-based mechanism for contracting and guaranteeing public debt. Going forward, we agree with staff that effective implementation of the law and developing a debt management strategy will strengthen the debt carrying capacity.

We note that China is the most important investor and the largest bilateral creditor, with the lending about US$ 3.8 billion in 2018. Therefore, we are of the view that reduction in exports and deceleration of FDI flows with China in an uncertain global environment are the most important risk factors for the Lao economy. While we see steady increase in FDI from China until 2018, we would like to know whether any early sign of FDI slowdown is observed more recently.

On the large investment project, such as Kunming-Vientiane railway, we agree with staff that the authorities should step up and frontload complementary reforms aimed at simplifying regulatory environment, improving adjacent infrastructure, logistical services, and trade facilitation networks. While we note the absence of the direct government guarantees on most of the projects, we have a concern that indirect contingent liabilities could emerge if utilization of project capacity is lower than anticipated. In this regard, could staff elaborate more on the economic impact of these projects with and without relevant reforms?

Financial Sector

Financial sector reforms should focus on financial deepening and strengthening resilience to risks. We positively note that the authorities have strengthened risk-based supervision based on the IMF's past advice. In addition, we welcome that the authorities have issued instructions removing interest rate caps in February 2019 in line with the past IMF advice. However, the regulatory guidance should be clarified. With a highly dollarized banking system, we agree with staff that high dollarization could amplify the external risks and further effort for de-dollarization is needed. In this regard, we would like to know more about the authorities' strategies for de-dollarization and staff's recommendation on this front.

Structural Reforms

Promoting competitiveness and inclusive growth is important structural reform agenda for the authorities. We concur with staff that putting investment in human capital at the center of the structural transformation and encouraging greater participation of women in the formal economy will help spread benefits of growth more widely. To make growth more inclusive, we think it is important for the authorities to improve educational attainment, skill training, reducing the regulatory burden on SMEs and improve access to finance.

Mr. Sigurgeirsson and Mr. Bernatavicius submitted the following statement:

We thank staff for the set of reports and Ms. Mahasandana and Mr. Abenoja for their informative buff statement. The authorities have shown determination to formally graduate from Least Developed Country status in 2024 after more than a decade of high growth and low inflation. Nevertheless, the economy remains vulnerable with elevated risks of debt distress, fiscal and current account deficits, low reserves, widespread poverty, and recurrent natural disasters. We broadly agree with staff's appraisal and offer the following points for emphasis.

We note positively the recent progress in reducing the fiscal deficit despite a challenging environment. Nevertheless, based on current policies, the fiscal deficit is expected to remain close to 4 percent, thus, it is crucial to step up fiscal consolidation. We welcome the authorities' determination to reduce the fiscal deficit to about 2 percent of GDP by 2025, as indicated in the BUFF statement. There is ample room to increase revenue mobilisation through a review of the tax policy and by modernizing tax administration, as indicated by staff. Additional fiscal space is clearly needed to mitigate weather related shocks and reduce widespread poverty, which has remained unchanged since 2005.

Lao's economy remains undiversified with widespread informality, low reserves, and an inflexible exchange rate. A more diversified export structure, as well as greater exchange rate flexibility, could provide a strong additional impetus in building reserves, which remains significantly below the adequate levels. Informal employment rates in Lao are among the highest in the world at over 90 percent, and women are more likely to participate in the informal sector. We welcome the staff's analysis in Appendix V, which indicates that reducing gender gaps would boost tax revenues and generate an additional 10 percent in long-run GDP growth.

We note, that Lao is amongst the top ten low income country CD recipients from the IMF, last year alone there were more than 40 IMF TA missions. We thank staff for the useful information provided in Appendix VI on Capacity Development. The Appendix would have benefited from more information and analysis on the TA missions provided by other donors and international organisations, as with such scale there is a danger of increased risk of duplication. Moreover, it would also have benefited from including the authorities' views. In the context of the exceptionally high amount of Fund TA, could staff elaborate more on the progress made in improving the absorptive capacity of TA?

We urge the authorities to consent to the publication of the report. We positively note that the authorities have approved the publication of the press release after the Article IV mission and we strongly encourage the authorities to continue this practice, which was not the case in recent years, as indicated in the BUFF statement.

Mr. Saraiva and Mr. Antunes submitted the following statement:

We thank staff for the reports and Ms. Mahasandana and Mr. Abenoja for the candor in their useful buff statement. Lao People's Democratic Republic (PDR) remains on a solid growth trajectory, despite extreme weather events – leading to record floods in 2018 – and the tragic collapse of a dam. Ongoing infrastructure projects have the potential to substantially change the country, fostering regional integration with China and dynamic ASEAN economies. Nevertheless, Lao PDR will be in a better position to reap the benefits of regional integration if the authorities strive towards fiscal and external sustainability, build adequate buffers and strengthen governance institutions. Addressing existing macroeconomic vulnerabilities and creating fiscal space for human capital and ongoing infrastructure investments will support Lao PDR's steady progress towards graduating from the Least Developed Country (LDC) status.

Improving domestic revenue mobilization could help creating the necessary fiscal space for strategic investments. Primary deficits have been reduced, but the public debt remains at relatively high levels. Moreover, a large share of the debt stock consists of external debt and is held by a single sovereign creditor. Therefore, staff's assessment of the risk of debt distress as elevated is a cause for concern. That said, two mitigating factors deserve to be accounted for. First, the fact that a substantial share of the debt is concessional, and second, the intergovernmental Power Purchase Agreements with neighboring countries, which provide a secure source of revenues. All things considered, we second staff's recommendations for additional fiscal consolidation measures, particularly on the revenue side, since tax revenues remain at relatively low levels.

The weak external position creates sizable risks for Lao PDR's economy in an uncertain world and regional economic environment. Current account deficits are projected to remain around 12 percent of GDP, and international reserves are insufficient, covering around 1.2 months of imports. Accordingly, staff assesses the external position as substantially weaker than implied by fundamentals and desirable policy settings. We take note that the authorities assess their reserve adequacy discounting imports related to FDI, which do not pressure the local exchange rate market for funding. The authorities' declared intention to strengthen the reserve position over time, as economic diversification boosts exports, is certainly positive. We also welcome the gradual approach towards exchange rate flexibility and the proposed institutional and legal measures to increase the traction of the monetary policy. Nonetheless, taking into account the prevalence of downside risks, we encourage the authorities to consider accelerating the building up of international reserves, in line with staff's recommendations.

Diversifying the economy, investing in human capital and empowering women are the most important challenges ahead for Lao PDR. Capital intensive mining and hydro-power sectors boosted Lao PDR's growth over the last decades. The country successfully positioned itself as an exporter of renewable energy, but spillovers for the rest of the economy have been limited. Going forward, mega-infrastructure projects connecting Lao PDR to China and the regional economy will open a unique window of opportunity to enhance economic diversification, step up social inclusion and structurally reposition the country's economy. We commend staff for the insightful Appendixes IV and V, respectively on economic diversification and the economic benefits of promoting gender equality. We encourage the authorities to consider staff's policy suggestions, and to keep working with international partners to consolidate Lao PDR's inclusive and sustainable development trajectory.

Mr. Palei and Mr. Potapov submitted the following statement:

We thank staff for the insightful report and Ms. Mahasandana and Mr. Abenoja for their informative buff statement. Over the recent years, the Lao P.D.R.'s economy has demonstrated high growth rates, supported by large FDI financing and infrastructure projects. While the natural disasters have led to slowing real GDP growth in 2018, the medium-term outlook remains favorable, driven by electricity exports and the completion of large railway projects. The authorities and staff seem to broadly agree on the key policy challenges and on corrective measures needed to further improve its performance.

The high level of public debt with low foreign exchange reserves weaken the cushion against negative shocks. The debt sustainability analysis indicates that Lao P.D.R. is at high risk of external and overall debt distress. Moreover, the estimated recovery needs from the 2018 natural disasters underscore the importance of strengthening the economy's buffers. Against this background, we welcome the authorities' fiscal adjustment efforts aimed at reducing the fiscal deficit to 4.3 percent of GDP in 2019 from 5.5 percent of GDP in 2017. We also support the authorities' plans to reprioritize capital investment in order to address infrastructure repair needs. We would encourage the authorities to conduct a Public Investment Management Assessment and Fiscal Transparency Evaluation, which will help increase capital spending efficiency and strengthen fiscal governance.

As suggested by Figure 2, the quality of fiscal consolidation is affected by underperforming revenues and spending compression. Moreover, staff argue that more ambitious fiscal consolidation is required to reduce the fiscal deficit to 2 percent of GDP and bring the public debt below 50 percent of GDP by 2025. The authorities are well advised to implement the PFM reforms and the MTRS, broaden the tax base, and strengthen public debt management. Low tax revenue/GDP ratio in Lao P.D.R. suggests ample room for additional base broadening, including through the modernization of tax laws and tax administration. In this context, we welcome the authorities' plans to review and adopt a rules-based tax incentives system. At the same time, could staff provide a detailed table with the key fiscal adjustment measures and their likely yields envisioned in the adjusted policy scenario?

The external sector assessment in Lao P.D.R. shows that external position remains highly vulnerable with overvalued currency, high current account deficit, and weak reserve coverage. While these estimates are subject to high uncertainty, we support staff's recommendations to move to a more flexible exchange rate regime, which will be instrumental in accumulating additional foreign exchange reserves. Staff argue for a very gradual approach, given currency mismatches on the balance sheets in the public, banking, and corporate sectors. In our view, a faster transition to a more flexible exchange rate regime may be needed to support the rebalancing of the economy and address the loss of competitiveness. In this context, we agree with staff that further improvements in the monetary policy framework and the development of domestic securities markets need to be advanced.

We welcome the authorities' efforts to address vulnerabilities in the banking sector. Profitability of the banking system is low, while the recent growth slowdown has led to the decline in credit growth. Some public banks are undercapitalized. Significant variation of NPLs across banks remains a concern. Further strengthening of risk-based supervision and resolution framework will help mitigate these risks. At the same time, we note the authorities' objection to staff's recommendation to raise foreign exchange reserve requirements in order to address foreign currency lending risks. Could staff elaborate on any alternative approaches in this area? As a related matter, could staff comment on additional measures that can help reduce dollarization?

The transition to a more inclusive growth model would require diversification of the country's growth drivers by investing in human capital, strengthening the business environment, and improving competitiveness. According to the report, the Lao-China Railway project could generate substantial positive spillovers to Lao P.D.R.'s economy. We agree with staff that maximizing these economic benefits would require further improvements in infrastructure, regulatory environment, and logistical services. Lao P.D.R.'s low ranking in the 2019 Doing Business Database also points to the scope for further reforms. Efforts in this area would be helpful in addressing challenges associated with governance and institutional weaknesses.

Mr. Trabinski, Ms. Brune and Mr. Imashov submitted the following statement:

We thank staff for the comprehensive set of reports, and Ms. Mahasandana and Mr. Abenoja for their informative buff statement. Lao People's Democratic Republic (PDR) has experienced strong economic growth over the past decade. Despite some slowdown caused by natural disasters, medium-term growth is expected to remain high, underpinned by private investment and FDI. However, important downside risks warrant prudent policy decisions going forward. In particular, we encourage the authorities to address the high level of public debt more forcefully and to step up reform efforts to achieve sustainable and more inclusive growth.

Accelerated fiscal consolidation and governance reforms are needed to address persistent debt vulnerabilities. Past capital investments have contributed to a continually high risk of debt distress. Thus, we see merit in streamlining the public investment framework, in particular with a view to freeing up resources to mitigate the impact of recurring natural disasters. It is also important to ensure that risks related to large-scale FDI projects are identified and mitigated, while projects themselves are designed in a way that they could fully benefit the local economy. Fiscal consolidation should rely more on revenue mobilization, including a prompt implementation of the medium-term tax revenue strategy. We take note of the increased concentration in the composition of Lao PDR's debt. We welcome the authorities' intention to improve the legal and institutional frameworks for PPPs. In this regard, could staff elaborate on whether the authorities are considering to undertake a PIMA?

Increased exchange rate flexibility would be beneficial. Increased flexibility would help strengthen the weak external position, and should go in hand with improving the liquidity management. In this context, we share staff's policy recommendations to further develop the debt securities market. Moreover, we take note of financial sector weaknesses and the need for a more comprehensive risk assessment. We encourage the authorities to proceed with a timely adoption of the Basel II framework, as well as with the implementation of risk-based financial sector supervision and IFRS accounting and reporting standards

Fostering economic diversification, human capital investment, and labor productivity will be essential to achieve more inclusive and sustainable growth. Simplifying business regulations, improving access to credit, and addressing corruption are key to improve the business environment for SMEs. In the longer term, skill shortages should be addressed with well-planned and executed education reforms and by allowing for greater participation of women in the formal economy.

Data deficiencies should be addressed. We commend the authorities for subscribing to e-GDDS. We encourage further efforts to address the shortcomings in economic and financial statistics listed in the Informational Annex. We encourage Fund TA to focus on strengthening government finance and external sector statistics, so as to assist Lao PDR in meeting its obligations under Article VIII, Section 5.

Mr. Sun and Ms. Lok submitted the following statement:

We thank staff for the thorough set of reports, and Ms. Mahasandana and Mr. Abenoja for the informative buff Statement. We welcome the notable progress made by Lao P.D.R towards graduating from the Least Developed Country (LDC) status. While long-term prospects remain positive, the economy continues to face significant challenges, including those arising from natural disasters. We encourage the authorities to continue to press ahead with reforms to strengthen policy frameworks and put growth on a sustainable and inclusive path. We broadly agree with the thrust of staff's appraisal and would like to confine our comments to the following.

The authorities are facing a difficult challenge of balancing between debt sustainability and developmental needs. An elevated level of public debt and risks to sustainability call for careful management of public investments and sustained fiscal consolidation. Improving the efficiency of public investment is key, and we welcome the authorities' efforts to prioritize the most impactful and growth-enhancing projects. Meanwhile, shifting more fiscal consolidation efforts to revenue mobilization would help maintain spending on social development and infrastructure needs. In this regard, we welcome the authorities' determination in improving tax administration and tax policy reform. The development of the Medium-Term Revenue Strategy with the support from Fund assistance is a step in the right direction and we look forward to the timely approval and implementation of the strategy. In addition, we encourage the authorities to further strengthen fiscal governance and capacity to facilitate better public financial and debt management going forward.

We are encouraged to note that Lao P.D.R's international reserve position is expected to strengthen over the medium to long term, as efforts to diversify the economy begin to bear fruit. The introduction of greater exchange rate flexibility should be proceeded with care and appropriate preconditions in place. To this end, we take positive note of the authorities' ongoing efforts to deepen the interbank market and develop the domestic debt and FX derivative markets. As for the financial sector, we welcome the developments that have been taken place to strengthen risk-based supervision and improve crisis management and bank resolution. We encourage the authorities to continue enhancing the financial system to allow it to fully play its role in supporting economic growth.

Economic diversification is critical to promoting sustainable and inclusive growth in the longer term. We strongly support the authorities' policy orientation towards enhancing human capital, as well as improving the business environment and public infrastructure. We share staff's view that transforming Lao P.D.R from a land-locked to a land-linked country would help improve trade connectivity and contribute to economic diversification. The ongoing Lao-China railway project is an important element of this transformation and represents a concrete example of how diversification can be achieved. The implementation of complementary reforms and measures, including improving adjacent infrastructure, logistical services, and the overall business environment, would help ensure that the potential benefits of the railway project and transformation can be fully reaped. In the meantime, we support efforts to promote SME development, strengthen governance, enhance the AML/CFT framework, and improve economic data.

As the authorities continue to pursue reforms on multiple fronts, support and advice from developmental partners including the Fund would be critical to ensure that policies are appropriately balanced and sequenced. We look forward to further progress in the next Article IV Consultation and wish the authorities every success in their policy endeavors.

Mr. Rashkovan and Ms. Harutyunyan submitted the following statement:

We thank staff for the comprehensive set of papers and Ms. Mahasandana and Mr. Abenoja for their insightful buff statement. We welcome Lao P.D.R.'s high growth and stable inflation over the past decade that has laid a solid foundation for the country's graduation from the LDC status.

Looking ahead, the medium-term outlook, despite prevailing downside risks, is favorable with robust growth and moderate inflation. That said, the economy remains confronted with significant vulnerabilities related to high public debt, large external imbalances, low international reserves, a managed exchange rate and a highly-dollarized financial system. Against this background, growth and export diversification to promote inclusive and sustainable growth is paramount. Most importantly, risks related to natural disasters continue to weigh on macro-sustainability and poverty reduction. We broadly agree with staff's assessment and would like to focus our comments on the following points: debt sustainability, fiscal governance and weather events.

We stress the importance of fiscal consolidation in putting public debt on a downward path while creating space for social spending. We note that Lao D.P.R.'s external and overall debt distress risks continue to be assessed as high and welcome the authorities' commitment towards continued fiscal consolidation going forward. While we acknowledge the challenges lying ahead and the recovery needs from the 2018 natural disaster, the reduction of the fiscal deficit in 2018 at the cost of lower capital spending is regrettable. The staff report underlines that the government has committed to fiscal consolidation mainly through expenditure consolidation while additional revenue generation could further support their efforts. In this vein, we would like to encourage Lao P.D.R.'s authorities to pursue staff's "policy scenario" which, in comparison with the baseline scenario, largely relies on the revenue mobilization efforts. We agree with staff that this will help reduce the fiscal deficit to around 2 percent of GDP and public debt to below 50 percent of GDP by 2025, while remaining aligned with the Sustainable Development Goals (SDGs). In this context, we would like to ask staff to elaborate further on the authorities' views in this regard, especially that according to the estimates fiscal consolidation requires additional revenues of 1.5 percent of GDP to achieve the policy scenario (Box 2).

Strengthening of fiscal governance and debt management will be crucial going forward. We stress the importance of enhancing revenue mobilization through improvements in tax administration and tax policy reforms. In this context, we welcome the development of the 2021-2025 MTRS and emphasize the importance of its timely approval and implementation. Could staff comment on the authorities' plans for the respective timeline in this regard. We also underscore the importance of further improvement of public finance management. While the adoption of the Public Debt Management Law in 2018 is a welcome step forward, we look forward to the effective implementation of the law. And finally, we would like to ask the authorities to remain cautious about the risks related to the emergence of contingent liabilities from the large-scale investment projects while enhancing efforts to strengthen legal and institutional frameworks for PPPs.

Strengthening the resilience against climate and natural disasters shocks is macro critical. We note that Lao P.D.R.'s exposure to the risk of natural disasters and the frequency of floods has notably increased over the last two decades, which underscores the need to build policy and financial buffers. The most recent natural disaster occurrences in Lao P.D.R. illustrate the impact that adverse climate developments can have on macro-critical economic indicators. As the DSA's shock scenario displays, this presents a major risk for the country's fiscal sustainability. To this end, we stress the importance of a comprehensive disaster risk management strategy to overcome challenges related to the constraints on financial resources and weaknesses in institutional and implementation capacity. In this vein, we welcome the ongoing work on the development of the National Financial Protection Strategy against Disaster and Climate Risks with support from the World Bank. Meanwhile, the increased focus on disaster risk management in the 2016-2020 NSEDP is well taken. Also, we fully support the authorities' commitment to participate in the first regional catastrophe risk pool under the Southeast Asia Disaster Risk Insurance Facility (SEADRIF) and believe that will help to mitigate the financing risks.

Finally, while the participation in the e-DSSA is an important step forward, we emphasize the importance of continued efforts on further improvement and timely dissemination of macroeconomic data supported by the TA from development partners. This is especially important in light of the assessment of Lao P.D.R. as a high-risk debt distress country.

With these remarks, we wish the authorities all the success in their future endeavors.

Mr. Ronicle and Ms. Freeman submitted the following statement:

We support staff's assessment of LAO PDR and thank Ms Mahasandana and Mr Abenoja for their informative buff statement. We note that Lao's growth trajectory remains strong and welcome the progress made in 2018 towards graduating from Least Developed Country status. We agree with the broad thrust of staff recommendations, particularly the need to reduce public debt and to invest in human capital to support inclusive growth. Overall, we wanted to highlight a few issues raised.

We agree with staff advice that the near-term priority should be on reducing the risk of debt distress through fiscal consolidation, including reducing the fiscal deficit and putting public debt on a firm downward path. Given social spending needs, we would have expected the debt consolidation to be more heavily weighted towards revenue mobilization, as per the staff suggestion. Could staff comment on the authorities' rationale for the current plans to reduce the deficit? We also agree with staff on the need to re-build the current low reserves so that the authorities' can better withstand external shocks and also on the need to further data transparency.

We noted the significant impact of natural disasters on GDP last year (2 percent) and the near and longer term risks of further natural disasters for the country, its people, and debt sustainability. We agree that there should be fiscal headroom created to support the authorities' ability to rebuild following recent disasters and respond to natural disasters in the future; however, the report highlights the trade-off that this will create between further investment in building resilience. Could staff comment on whether discussions have been had with international partners and other international finance institutions to support the financing of both priorities: disaster response and resilient investment? We also welcome the inclusion on natural disaster risks in the Debt Sustainability Analysis.

On diversifying growth drivers, we agree with the recommendation to further investment in human development. While growth is welcome, for it to be sustained in the long-term it needs to harness the potential of all of Lao's population, including those in rural areas and women. Under the World Bank Human Capital Index Lao scores 0.45 (meaning the population are realizing under half of their human capital potential) and under the Human Development Report on Gender Inequality Lao is ranked 109th. In comparison, Vietnam and Thailand score 0.67 and 67th, and 0.60 and 93rd respectively. Could staff comment on whether there are any policy lessons that Lao can adopt from regional partners?

We also noted that the authorities are re-assessing their investment pipeline. Do staff have a view on timelines for this assessment and the key priorities for investment within social spending and resilience?

Lastly, looking forward, in 2020 Lao will have a full FATF review and implementing anti-corruption and CFT measures ahead of this should be a priority. We agree that TA from development partners should support this. Could staff comment on where conversations are on this?

We also would like to thank Staff for the informative annex on capacity development, which sets a good example for other reports.

Mr. Johnston and Mr. Shin submitted the following statement:

We thank staff for their comprehensive reports on Lao PDR and Ms. Mahasandana and Mr. Abenoja for their informative buff statement. Lao PDR has had impressive economic growth over the past decade and the medium-term outlook is favorable, with annual growth projected to be around 7 percent. However, macro-vulnerabilities remain. We broadly agree with the staff assessment and have the following comments for emphasis and clarification.

Given the high risk of debt distress, fiscal consolidation with firm discipline should be sustained. While recognizing that natural disasters and the tragic dam collapse have resulted in revenue shortfalls and urgent spending needs, continued fiscal deficits of over 4 percent are a concern. As the DSA shows, public debt is still elevated (57.2 percent of GDP as of 2018) and stress tests indicate the vulnerability of the debt path to shocks from the external environment and contingent liabilities. Additional consolidation could be achieved by rebalancing efforts from expenditure compression to revenue generation, and especially by focusing on broadening the base of VAT and corporate income tax. In this regard, we welcome the development of the MTRS, with support from FAD, and hope for its timely approval and implementation. We also share the view of staff that the authorities can take advantage of the current moratorium on new projects to improve the efficiency of capital spending, possibly with a Public Investment Management Assessment (PIMA).

Further efforts to address external vulnerabilities would be warranted in the face of growing external uncertainty. The current account deficit remains very high at over 12 percent of GDP and the exchange rate is tightly managed with low FX reserves. The external assessment is alarming, pointing at a significant overvaluation and a large current account gap. While noting the need for greater exchange rate flexibility, we also see merit in a gradual and well-sequenced reform in the FX market, recognizing the possible inflation pressure and the balance sheet effect on banks and corporates. We generally concur with staff's suggestions to widen the FX trading band, strengthen the FX trading infrastructure, and develop the spot market. Do the authorities have a long-term plan for FX market reform? Could staff also elaborate further on the degree of financial dollarization in the market and how it affects FX market reform and development?

Structural reforms to promote higher and more inclusive growth should continue. As skills shortages are considered one of the key barriers to doing business in Lao PDR, providing quality education and vocational training would help the country grasp the promising opportunities for foreign investment, trade and tourism. Promoting women's participation in the workplace would also have important pay-offs, given the encouraging analysis that implementing gender-related policies could generate an additional 10 percent in long-run GDP growth. In addition, developing public infrastructure, improving regulatory environment, and enhancing financial access by SMEs would help promote private sector-driven growth and job creation.

Mr. de Villeroché, Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for the quality of their document and Ms. Mahasandana and Mr. Abenoja for their insightful buff statement. While Lao's economic performance remains robust, the economy faces several macro-vulnerabilities that call for rebalancing measures. Dealing with public debt vulnerabilities underlined by the DSA should be a priority while long term development goals call for a broad structural reform agenda. While we agree with the thrust of staff appraisal, we would like to make the following comments for emphasis:

We support staff recommendations to reduce public debt vulnerabilities by adopting revenue-based consolidation measures and improving public financial management. We encourage the authorities to design and implement an ambitious medium-term revenue strategy to reduce the public debt and finance the significant social spending needs of the country. Structural fiscal reforms in the field of PFM, debt and public investment management will also help to create fiscal space and ensure the viability of public infrastructure projects that are partly financed by foreign countries. We take note of the DSA result but would appreciate if staff could elaborate on the PPP shock scenario. We notably have trouble to appreciate whether such a shock is realistic given the mentioned strong track record of implementing energy exports from mega- power projects. In addition, we commend the authorities for joining e-GDDS. Going forward, we encourage them to tackle remaining data gaps and encourage staff to adequately plan technical assistance in the field of debt data recording.

We agree with staff that the external position is a source of vulnerability. Having a more flexible exchange rate regime could help to rebalance the current account while building FX reserves. Modernizing the Central Bank operations, developing debt markets and strengthening banks supervision are also necessary measures to safeguard macro-financial stability and conditions for greater exchange rate flexibility.

Lao being exposed to natural disasters, we agree with staff that the country should fully integrate disaster management risks in all its policy making process. We thank staff for its annex on this important challenge and encourage further analysis on this issue in future Article IV reviews. Given the economic and human cost of the XePian XeNamnoy dam collapse in 2018, we strongly encourage the authorities to improve the governance of dams safety, notably through stricter inspection procedures and a strong accountability framework. In addition, could staff provide an update on the impact on the economy of the recent intensification of the dengue and swine fever epidemics as well of the drought?

Regarding structural measures, we support staff’s call to significantly increase investment in human capital and enhance efforts to fight corruption. Lao is lagging peers in terms of human capital development which could rapidly become a major growth constraint. Higher public spending in health and education as well as measures to improve service delivery in these two sectors are essential. While we commend the authorities for the recent measures taken to combat corruption we agree with staff that these actions must translate into a de facto improvements in the business climate. We encourage staff to pursue its dialogue with the authorities on this issue, notably with the upcoming 2020 full FATF assessment in sight. We also thank staff for their insightful annex on economic diversification and gender equality. Staff and authorities should follow up on the recommendations highlighted by these analytical contributions.

We thank staff for its detailed annex on technical assistance which shows the good integration between surveillance and capacity development.

Coordination with other technical assistance providers is also essential to maximize CD impact.

Finally, we encourage the authorities to publish this Article IV report.

Mr. Moreno and Ms. Mulas submitted the following statement:

We thank staff for its papers and Ms. Mahasandana and Mr. Abenoja for their candid buff statement. We broadly agree with staff's appraisal and main recommendations, and would like to emphasize the following points:

Growth needs to be more inclusive. Notwithstanding the flooding-related disasters, we welcome that Lao PDR continued to register robust growth and a low inflation in 2018. However, poverty levels remain mostly unchanged since 2005, despite that Lao PDR has experienced more than a decade of high growth. To spread the benefits of the strong growth should be a priority. We welcome that the government is aware of this challenge and is committed to pursue prudent macroeconomic policies and to carry out the reform agenda to build the foundations for a durable, sustainable and inclusive economic growth, as stated in the buff's statement. We welcome that the government's declared objective for the next five-year plan is to rebalance the economy from a resource-based to a more diversified growth model by investing in human capital and improving competitiveness, in line with staff's recommendations. We encourage the authorities to take advantage of the positive outlook to accelerate its economic diversification strategy to enhance a more inclusive growth.

Risks are titled to the downside and vulnerabilities are high. We agree with staff that risks stem from external development. As noted in the staff's report, not only the overall diversification levels remain low but also exports are expected to become even less diversified, making Lao PDR highly dependent on the demand of electricity from neighboring countries. We are less concerned about the risks from the tightening of global financial conditions due to the last developments. Staff's comments are welcome. We would like to emphasize the vulnerabilities to natural disasters as it is an overarching threat to health and livelihoods, as seen in the recent flood. Besides, our past concerns still hold: imbalances are looming, and fiscal and banking system vulnerabilities could cost the country dearly if an external shock were to materialize.

Creating fiscal space for inclusive development is relevant. Fiscal space is limited due to the high level of public debt, weak external position, and limited market access. Like staff, we see a need to rebalance the composition of fiscal consolidation from expenditure compression towards revenue mobilization to enable more spending on social development. We welcome the reorientation of spending towards better outcomes in line with the Sustainable Developments Goals (SDGs), and we encourage the authorities to continue on this path. We share staff's views on the importance of strengthening institutional capacity to manage debt, as well on the importance of assessing the risks from contingent liabilities.

External position is particularly weak. Both models used at the External Sector Assessment point out that the external position in 2018 was substantially weaker than that consistent with medium-term fundamentals and desirable policy settings. We are particularly concerned on the level of the gross official reserves which continues to be below 1.5 months of imports for the third year in a row. However, we note that the authorities adjusted the reserve level considering non-FDI-related imports given that most of the FDI-related projects use their own funding which are unrelated to the international reserves at the central bank. Could staff elaborate on this adjustment? This chair has repeatedly stressed the benefits of exchange rate flexibility to absorb external shocks, and we continue to believe that Lao's ability to weather them would be greatly enhanced with a more flexible exchange rate. In this vein, we support staff's recommendation of allowing the exchange rate to depreciate gradually to regain competitiveness and accumulate reserves.

The pace of financial reforms needs to be accelerated. We welcome the progress to improve bank regulation and supervision and we encourage the authorities to keep on deepening the financial system, strengthening the resilience against foreign and domestic risks and reducing dollarization. We commend the authorities for the progress in improving the AML/CFT framework. We would like to emphasize the need for greater financial inclusion and literacy to improve access to finance, particularly to SMEs and women.

Finally, we would like to encourage the authorities to publish this Article IV report.

Mr. Di Tata and Mr. Morales submitted the following statement:

We thank staff for a clear report and Ms. Mahasandana and Mr. Abenoja for their informative buff statement.

Lao P.D.R. has experienced an impressive long period of high growth and low inflation. Real GDP growth remained above 6 percent in 2018 despite heavy rainfalls affecting agriculture and manufacturing. Going forward, growth should rise gradually, supported by private investment, electricity exports, and the completion of the Kunming-Vientiane railway project. However, an additional effort to build buffers appears necessary as external risks are tilted to the downside. We agree with staff that containing public debt and building up international reserves would be key to enhance the country's resilience in the event of external shocks.

Decisive steps toward fiscal consolidation are required to put the public debt on a sustainable path. The Laotian government managed to bring down the fiscal deficit to 4.4 percent of GDP in 2018 despite revenue underperformance and an increase in emergency assistance for public works, transportation, agriculture and forestry, which were affected by the natural disasters. This was only possible because of a significant reduction in investment. Looking ahead, the fiscal effort should be rebalanced to give more weight to improving the revenue potential, especially given estimated tax exemptions equivalent to 80 percent of the corporate tax base, which create a revenue gap of 4.5 percent of GDP. In this connection, we welcome the ongoing rollout of the electronic tax payment systems for the value-added tax and the income, road, and land tax revenue collections, and encourage the authorities to embark on an overhaul of tax incentives to move towards a rule-based system. In parallel, the prompt approval of a medium-term revenue strategy in line with staff recommendations should be complemented by public financial management (PFM) reforms to enhance spending efficiency, prevent the re-emergence of spending arrears, and ensure the availability of fiscal resources in the event of weather-related shocks.

We welcome the authorities' focus on managing the potential risks of debt distress in view of the high level of public debt and the increasing share of non-concessional financing sources, as highlighted by Ms. Mahasandana and Mr. Abenoja. We understand that the significant share of electricity export earnings under long-term intergovernmental power purchase agreements and the moratorium on new capital investment projects would help contain debt accumulation. However, fiscal space is low, as debt remains high and the external position weak. Moreover, the downward revision of the Country Policy and Institutional Assessment by the World Bank in the areas of fiscal and debt policies is a concern. We support the staff's recommendations to narrow the fiscal deficit to two percent of GDP and bring public debt below 50 percent of GDP by 2025, with the support of PFM reforms and measures to broaden the tax base. This should be complemented by the prompt implementation of the new Public Debt Management Law, which introduces a five-year debt management strategy that encompasses the upgrade of debt recording systems, an expansion of assessments of direct and contingent debt exposures, and the enhancement of risk management practices.

Increasing exchange rate flexibility and improving Lao P.D.R.'s competitiveness are necessary steps to strengthen the overall external position. The central bank (BOL) should consider a gradual widening of the exchange rate trading band, accompanied by measures to strengthen the FX trading infrastructure and develop the foreign exchange spot market. In the near term, incorporating seasonal factors affecting the foreign exchange market into the BOL's liquidity forecasting exercise would protect the reserve buffer. Reserve accumulation by the central bank should be mindful of exchange rate developments, given banks and corporates' currency mismatches.

We commend the authorities for lifting caps on bank deposit and lending interest rates. We encourage the Laotian government to take advantage of this opportunity to introduce policies encouraging financial inclusion, so that the expected rebound in credit growth benefits a larger share of the low-income population. We also agree with staff on the need to simplify the regulatory environment for small and medium enterprises, improve financial literacy, and tailor training programs for female business owners. In parallel, full adoption of risk-based banking supervision and introduction of international accounting standards would allow better identification and prompt mitigation of risks. In this regard, banks' balance-sheet currency mismatches should be addressed decisively, including by considering raising reserve requirements on foreign exchange liabilities, as recommended by staff.

The Laotian economy shows scope to move to higher potential growth rates. The authorities should step up efforts to address key structural problems such as skill shortages, high informality, and burdensome legal and regulatory systems. Closing gender gaps in educational attainment and reducing barriers to female labor force participation could have a significant impact on long-run growth. Also, investments associated with the Belt and Road Initiative would help bridge infrastructure gaps if large power and railways project capacity were utilized optimally. Moreover, adequate reallocation of government fiscal resources in the context of PFM reforms would help align government spending priorities with Sustainable Development Goals. Finally, developing a disaster recovery framework to optimize prevention and recovery efforts would help mitigate the impact of recurrent natural disasters on long-term growth.

We encourage the authorities to improve the AML/CFT framework to prepare for the 2020 FATF assessment, based on the National Risk Assessment completed in 2017-18. More broadly, the effectiveness of the framework to address corruption should be reviewed in light of continued perceptions of corruption vulnerabilities.

With these comments, we wish the authorities every success in their policy endeavors.

Mr. Raghani and Mr. Diakite submitted the following statement:

We thank staff for the set of reports and Ms. Mahasandana and Mr. Abenoja for their informative buff statement.

Economic growth remained strong at 6.3 percent in 2018 but decreased slightly compared to 6.8 percent in 2017, due mainly to natural disasters shocks. Fiscal consolidation efforts brought the deficit down to 4.4 percent of GDP and inflation was contained below 3 percent. The current account deficit widened owing to megaprojects and natural disasters related imports. In addition, international reserves dropped to the equivalent of one month of imports. Going forward, we note that the economic outlook of Lao People's Democratic Republic (Lao P.D.R.) is positive, supported by private investments, electricity exports and transport projects. Real GDP is projected to hover around 7 percent in the medium term. Notwithstanding this favorable prospect, the economy faces significant vulnerabilities, including the high debt and insufficiently diversified economy, which would need to be addressed to foster broad-based and inclusive growth. We broadly concur with staff's policy recommendations and provide the following comments for emphasis.

Sustained fiscal consolidation and management of fiscal risks are essential to reduce further the fiscal deficit and public debt, while increasing buffers to mitigate exogenous shocks. The high level of debt and risk of debt distress represent an important source of macroeconomic vulnerabilities that should be tackled through increased fiscal consolidation. The authorities' commitment in this regard as indicated in the buff statement is welcome and we take positive note of the envisaged measures on the expenditures side, including the reduction in the recruitment in the public service. Given that the country is exposed to natural disasters, we see merit in diverting part of the capital spending in favor of building buffers for ex-post disaster reconstruction. We would appreciate further comments on the efforts to build social resilience including the provision of social safety nets following natural disasters.

We also share the view that rebalancing fiscal adjustment towards revenue mobilization is necessary to create fiscal space for addressing the important development challenges facing Lao P.D.R. We encourage the prompt approval of the medium-term revenue strategy which aims to broaden the tax base and improve the efficiency of tax administration. Regarding debt management, we welcome the new public debt management law and call for further efforts to develop a medium- to long-term strategy which will address institutional aspects as well as risk management.

Increasing foreign exchange reserves is paramount to strengthen resilience to external shocks. We note the assessment of the overall external position which, with the high level of indebtedness and low level of reserves, is a one of the main vulnerabilities of the economy. The authorities should continue improving the framework for the management of foreign exchange operations. They should also gradually allow greater exchange rate flexibility in light of the low level of reserves, and we urge the effective implementation of the needed reforms in this regard, including improving the interbank and domestic debt markets. We also agree that fostering capital investments to enhance competitiveness as envisaged in the authorities'5-year plan, and advance economic diversification will be essential to reinforce the external position in the long term.

The authorities should remain vigilant to financial stability risks and further deepen the financial sector. The banking sector is well capitalized but requires continuous risk assessment. In this regard, we welcome the efforts made to reinforce the framework for risk-based supervision, the adoption of the new Commercial Bank Law as well as the use of financial soundness indicators to better monitor the banking sector. We encourage further progress towards the IFRS accounting and reporting standards as well as the Basel II framework as these actions are important for strengthening financial sector stability. It will also be important to continue deepening the financial system to facilitate access to credit for small and medium enterprises in the context of the government's growth diversification strategy.

We encourage the implementation of structural reforms aimed at transforming the natural resource-based economy, improving the quality of human capital, and upgrading the country to an upper middle income status.

Expanding economic diversification and attaining the upper middle income status will require increased investment in human capital through upgrading education and vocational training. Further measures to address gender disparities in education and formal employment to achieve more inclusive growth will be needed. Moreover, given the authorities' objective to make Lao P.D.R. an upper middle-income country, reforms to further improve the business climate and governance and attract more trade and private investments should be pursued. In this regard, the support to SMEs development as a vehicle to diversify the economy and bolster inclusive growth should rank high in the government's priorities.

With these remarks, we wish the authorities of Lao P.D.R. continued success in their endeavors.

The Acting Chair (Mr. Furusawa) made the following statement:

After many years of solid growth and low inflation, Lao PDR is consolidating its progress toward graduating from the least developed country (LDC) status. Economic expansion is expected to continue, however, the country faces challenges. Going forward, it is important to maintain prudent macroeconomic management while pursuing economic reforms. In particular, Directors have noted the need for strong policies and reforms aimed at addressing vulnerabilities, sustaining fiscal consolidation to ensure debt sustainability, and fostering sustainable and inclusive growth. Directors have also highlighted the importance of improving the quality and timeliness of economic statistics.

The staff representative from the Asia and Pacific Department (Ms. Kvintradze), in response to questions and comments from Executive Directors, made the following statement:[4]

We share Directors' recommendations, and we recognize that Lao PDR is at an important point, where it starts to transition from a more resource-driven to an inclusive growth model. This transition opens an opportunity to address longstanding structural vulnerabilities.

Addressing debt vulnerabilities through a gradual revenue-based fiscal consolidation remains a priority. This should help to reduce debt and build

[4] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

fiscal space for much-needed social and development spending, as well as natural disaster mitigation and preparedness.

As Lao develops, its debt profile is changing. This requires a continuous upgrade to its debt management systems and capacity. The large stock of public-private partnerships (PPPs) needs an agile risk assessment framework, taking into account project-specific cycles.

Strengthening governance and transparency is a cross-cutting issue. Developing legal frameworks in fiscal, monetary, and financial management is a first necessary step which needs to be followed with effective implementation. In this context, the authorities' efforts to automate government services are a step in the right direction. This opens an opportunity to rethink and to reconfigure business processes, with a view to simplifying and making them more transparent.

Lao is expected to get more integrated with the regional trade links. Investing in people through better education, skills training, and applying inclusive policies are important factors to reap the benefits of this integration.

Lastly, this morning we received notification from the authorities that they consent to the publication of the staff report.

Mr. Daïri made the following statement:

I thank staff for their informative set of reports and Ms. Mahasandana and Mr. Abenoja for their helpful buff statement.

I commend the authorities for sustaining high economic growth with low inflation in recent years, noting that the slowdown in 2018 was due to natural disasters on top of slowing demand in partner countries. Medium-term economic prospects are also favorable, which will hopefully help Lao PDR graduate from the LDC status. However, the country continues to face important challenges and risks. I take comfort from the indication in the buff statement that the authorities are committed to pursuing prudent macroeconomic policies and to carry out their reform agenda to build a foundation for durable, sustainable, and inclusive growth. To this end, the focus in the policy discussion on fiscal consolidation, building up reserves, increasing competitiveness, diversifying the economy, and strengthening resilience to natural disasters is appropriate.

Since I agree with the thrust of the staff appraisal, I only have a few points to make.

I commend the authorities for the reduction in their fiscal deficit in 2018 and their intention to reduce it further, to 2 percent of GDP by 2025, consistent with their objective of bringing public debt down to 50 percent of GDP. A strong implementation of their ambitious fiscal reform agenda will be crucial for achieving the authorities' fiscal consolidation objectives, creating fiscal space for pro-growth/pro-poor spending, and putting public debt on a firm downward trend.

I welcome the authorities' intention to modernize the monetary framework and reduce dollarization. In this regard, developing a securities market will be helpful. Strengthening financial supervision to enhance resilience and improve small- and medium-sized enterprises' (SMEs) access to finance will help the authorities' diversification and inclusive growth objectives.

On the issue of reserves adequacy, I tend to sympathize with the authorities' methodology that excludes imports related to foreign direct investment (FDI) from the denominator, since most FDI-related projects are financed from investors' own foreign assets and not from central bank reserves. This being said, I welcome the authorities' recognition of the need to increase international reserves.

The authorities' goal of diversifying the economy, achieving broad-based growth, and enhancing resilience, as well as making further progress in improving education and skills are important for increasing employment, particularly in the formal sector, and reducing inequality. Strong reform implementation in this area will also be crucial. In this regard, while I appreciate the analysis on female labor market participation and unemployment, I missed an indication in the staff report of recent trends in total unemployment.

Finally, I noted that the last selected issues paper dates back to 2007. Could staff clarify why they do not see the need for such analytical work in Lao PDR's case?

I wish the authorities further success.

Ms. Levonian made the following statement:

We did not issue a gray statement, so I just wanted to raise a few points.

We commend the authorities for their progress in achieving high economic growth and poverty reduction. While these achievements are notable, Lao PDR continues to face significant vulnerabilities, including high public debt, low international reserves, and increasingly frequent climate shocks.

While we broadly agree with staff's assessment, there are just three specific points that I want to raise.

First, the high risk of debt distress should remain a key priority. Going forward, investment plans should focus on projects with credibly high rates of return and those which mitigate natural disasters. In this regard, the authorities' new public debt management law has the potential to be an important governance tool. Developing a debt management strategy would further strengthen debt-carrying capacity.

As with other countries in my constituency, increasing, frequent, and severe natural disasters underscore the need for enhanced climate resilience. Last year's tragic floods had a significant adverse effect on the economy and on the fiscal stance. Going forward, we encourage the authorities to create adequate fiscal space to mitigate against climate shocks and their economic and social consequences. We support staff's advice that these buffers should be built through revenue mobilization, rather than further expenditure compression. We also welcome progress in developing a comprehensive resilience strategy. In this regard, we recognize that Lao PDR has the intention to participate in the new Southeast Asia Disaster Risk Insurance Facility (SEADRIF). Many countries in our constituency have benefitted from participating in the Caribbean Catastrophe Risk Insurance Facility (CCRIF), which is a similar regional catastrophe risk pool in the Caribbean.

Finally, and importantly, as Mr. Daïri also mentioned, efforts should be made to ensure the benefits of growth are more inclusive. In particular, closing gender gaps in educational attainment, reducing barriers to female labor force participation, and promoting formal employment should be a key priority. We underline staff's conclusion that these policies would help to reduce gender inequality in earnings, boost tax revenues, and generate additional long-run GDP growth. We commend staff for its excellent annex on this important issue and encourage further analysis in future Article IV reviews.

With that, we wish the authorities all the best.

Ms. Crane made the following statement:

We issued a gray statement but wanted to follow up on a couple of points.

Revenue mobilization is critically important to bending the trajectory of debt while supporting needed development spending. We are heartened that the authorities are embracing Fund capacity development assistance in developing a Medium-Term Revenue Strategy (MTRS), and we took note of their plans for parliamentary consultations on the MTRS during 2020.

We hope that persistent efforts with the revenue strategy—including reforms to the income tax system, the possible introduction of a land and residential property tax, and efficiency administration of the value-added tax (VAT)—will put the authorities in a position to reduce their reliance on expenditure compression. We also hope that the process of developing and implementing the MTRS will help advance budget transparency and good fiscal governance.

We thank staff for their answer to our question on debt data gaps. We commend staff for their coordination with the World Bank to promote the upgrading of Lao PDR's debt management and financial analysis system. We also welcome the new public debt management law and appreciate that the authorities are working closely with the World Bank on a medium-term debt strategy.

Regarding obligations under Article VIII, Section 5, on provision of data to the Fund, staff answered our question with an emphasis on the international investment position (IIP) statistics, where progress seems to be in train. Could staff elaborate on what steps are needed to put the authorities in a position to report on the stocks of central government and central government-guaranteed debt to the Fund, as required by Article VIII? This is a key set of data, and we want to better understand what a realistic timeframe might be for the authorities to report.

We also echo the Moroccan and Canadian chairs on the importance of their efforts on gender equality.

Finally, we welcome the authorities' agreement to publish the Article IV report.

Mr. Antunes made the following statement:

We issued a gray statement, so I will keep our intervention brief. I would like to raise three points for emphasis.

First, we fully understand that Lao PDR’s economy presents many specificities. The country has been passing through a substantial process of transformation over the last decade, and long-run perspectives are promising. Nevertheless, we agree with many other Directors that accelerating a revenue-based fiscal consolidation and external rebalancing is key to reduce risks in an uncertain international and regional environment. In that context, building higher levels of international reserves is particularly important.

Second, we appreciated Appendix IV on economic diversification. The paper makes a compelling argument that capital-intensive growth has generated limited spillovers to the rest of the economy. We are encouraged by the authorities’ focus on SMEs, as they have the potential to make Lao PDR’s development process more inclusive and broad-based. Investing in human capital will be crucial to increase productivity in the medium run.

Third, we also appreciated Appendix V on the economic gains from promoting gender equality. Gender equality is a moral imperative and should be promoted in its own right, but it is always helpful to see the economic benefits spelled out so clearly. We agree that policies addressing gender inequality are relevant to Lao PDR’s strategy of economic diversification, human capital development, and sustainable growth. Therefore, it is clearly a macro-critical issue. We encourage staff to include similar analyses in other Article IV exercises, including for developed countries, where gender pay gaps and other forms of inequality still exist.

Mr. Saito made the following statement:

As we have issued a gray statement, I would like to briefly offer three comments for emphasis.

First, on fiscal policy. we share the staff’s concern that Lao has no fiscal space due to the high level of public debt and the weak external position. Therefore, faster fiscal consolidation, mainly through revenue mobilization, is needed to create more fiscal space for spending on social development. Specifically, we encourage the authorities to strengthen fiscal governance by steadfastly implementing the MTRS.

Secondly, on debt management, we are concerned that the risk of debt distress is high and debt-carrying capacity has deteriorated. In this regard, we welcome that the new public debt management law set a more rule-based mechanism for contracting and guaranteeing public debt. We encourage the authorities to effectively implement the law and to develop a debt management strategy to strengthen the debt-carrying capacity.

Regarding the large investment project, it is important to implement complementary reforms to achieve maximum benefit from the project and to mitigate the risk of the emergence of contingent liabilities.

On the issue of debt transparency, we welcome the progress so far to strengthen debt statistics, supported by the Fund's technical assistance (TA). Like Ms. Crane, we encourage the authorities to further improve the economic statistics, including recording of the debt data going forward.

Finally, on the financial sector, we concur with staff that the high dollarization could amplify the external risks and that further efforts for de-dollarization are needed. In this regard, while we welcome that the authorities have undertaken some measures to promote the use of domestic currency, we urge the authorities to establish a comprehensive medium-term strategy for de-dollarization. On this front, we would like to hear staff's view on the effectiveness of the authorities' measures on de-dollarization, such as a promotional campaign or strict enforcement of legislation on domestic transactions to be based in Lao kip.

With these remarks, we wish the authorities all success in their future endeavors.

Mr. Trabinski made the following statement:

We welcome the economic progress achieved by Lao PDR and commend the authorities for their fiscal consolidation efforts in a difficult environment, following natural disasters. In addition to our gray statement, we would like to highlight two more points.

First, we would like to join Mr. Merk in underscoring the importance for large-scale FDI projects to be anchored locally, especially by integrating secondary infrastructure into these projects. Moreover, given the fact that the past few intensive investments have had limited spillover effects on the local economy, we deem it important to create conditions in which these projects could be supported by local supply chains, thus creating beneficial linkages between investments and the rest of the economy.

In addition, we would like to stress the importance of adequate and timely provision of data, as was also pointed out by Ms. Pollard, Mr. de Villeroché, and Mr. Rashkovan in their gray statements. We commend participation in the enhanced General Data Dissemination System (e-GDDS) and welcome that staff expects the Fund to receive the first full set of IIP data from the authorities by July 2020, as stated in the written answers.

We also note that Government Finance Statistics (GFS) data are now being published on the government's website. While we are aware of the authorities' request for TA to improve national accounts and general data provision, we would appreciate if staff could clarify whether there are any plans to provide further Fund TA to the authorities to address the remaining capacity constraints, such as in the provision of monetary and financial statistics or central government debt, as already mentioned by Ms. Crane.

We commend the authorities for agreeing to publish their report, and we wish them success in their policies.

Ms. Mulas supported the points made by Mr. Antunes and other Directors on gender issues, and commended Appendix V on the economic gains from promoting gender equality. She encouraged staff to continue studying those issues.

Mr. Alkhareif made the following statement:

The benefit of speaking toward the end of the meeting is that you can summarize what your colleagues mentioned.

I would like to associate my remarks with those of Mr. Daïri, Mr. Saito, Ms. Crane, Ms. Levonian, and Mr. Trabinski, particularly with their comments on the fiscal side. Their efforts to improve public debt management is of particular importance to the country, and we encourage the authorities to do more in this area. Increasing reserves accumulation will help the country to manage the external shocks.

We also encourage the authorities to continue their efforts to improve inclusiveness and to close the gender gaps, as also mentioned by my colleagues.

The capacity development needs of this country are very high, and we encourage staff to engage closely with the authorities to meet the capacity constraint needs going forward.

Finally, like others, we welcome the indication that the Article IV report will be published.

The staff representative from the Asia and Pacific Department (Ms. Kvintradze), in response to further questions and comments from Executive Directors, made the following additional statement:

With regard to de-dollarization, we see that the indicators of dollarization for both loans and deposits stay more or less stable, with very slight variation. We understand that to achieve long-lasting impacts on those indicators requires putting in place not one reform but probably a combination of many.

The authorities are doing reforms in terms of improving the efficiency of payment systems, as well as automating some of the payments that we see, like taxes and some other government fees, which are expected to catalyze the use of domestic currency. Since those platforms are just being developed, the impact could be felt later. But overall, all these automations and payment platforms should also be considered in an environment where there is greater exchange rate flexibility. We saw that in 2018 and 2019, the exchange rate has been gradually depreciating. Allowing greater flexibility on both sides and putting in place frameworks to ease payment systems in the long term should help the usage of the domestic currency. We take note of the suggestion to have a long-term plan and medium-term plan for de-dollarization and will consult with the authorities on that in the next cycle.

In regard to the unemployment question, Lao PDR has a very high share of agriculture, with 90 percent of the population engaged in agriculture. It suggests a very high level of informality, which was discussed in the context of gender inclusion.

The government conducts official surveys every five years. The last survey was done in 2017, and official data reports only 9 percent of unemployment. But given the high informality, probably the actual unemployment is higher. That is what we had seen in various surveys, including on gender inclusion.

On central government debt data reporting, the authorities are submitting data on central government debt to the Fund and to the World Bank debt reporting systems on a regular basis. Where we see a need to improve is on updating systems that are used to record the data, because the version that they are using is outdated. It will improve the overall usage and the efficiency of the debt data.

We also see a need to better understand the risks related to PPPs, and this requires project-specific knowledge. Some of that knowledge is in the Ministry of Energy, the Ministry of Mining. The Ministry of Finance is collaborating with those ministries to be able to fully and better capture that sector-specific knowledge in their overall debt assessments and views. We are working with them in that direction. As we understand, the World Bank is providing very significant TA in both debt management, as well as upgrading the recording systems. We are collaborating with them.

With regard to the TA plans, we see the authorities very actively taking up TA on national accounts, statistics, e-GDDS. Our colleagues from the Statistics Department (STA), as well as from the Regional Technical Assistance Center (RTAC) in Bangkok, the IMF Capacity Development Office in Thailand (CDOT) give us a positive assessment of all the efforts and progress that the authorities are making in this direction. Just last week, we received follow-up requests to continue TA on national accounts, which we were already providing, and we are happy to endorse that.

Ms. Mahasandana made the following concluding statement:

On behalf of our authorities, we would like to thank Ms. Kvintradze and mission team staff for their constructive engagement during the Article IV consultation mission and for responding to the technical questions. We also thank Directors for their interest in the Lao economy and for the valuable comments expressed in their gray statements and in today’s oral interventions. We will convey these comments and suggestions to our authorities.

The Lao economy continued to grow robustly in recent years, although there was some slowdown last year, partly due to the impact of natural disasters. There were several favorable aspects of the macroeconomic performance. Inflation remained manageable. The fiscal deficit has narrowed. The current account deficit was broadly steady but remained high. The banking system continued to grow. However, as Directors point out in their written statements and oral interventions, the authorities face the major challenge of diversifying the economy while managing the still wide imbalances in the fiscal and external sectors, and fighting poverty and inequality. These issues need to be addressed head-on to be able to reduce macroeconomic vulnerabilities, satisfy the development needs, and sustain the improvements toward the Sustainable Development Goals (SDGs). It is in this spirit that the authorities have taken decisive actions to implement prudent macroeconomic policies and pursue transformative reforms.

On fiscal policy, we would like to assure Directors that the authorities are committed to improving revenue mobilization and promoting quality expenditure as a key component to their fiscal consolidation and to build fiscal buffers, especially to address long-term structural issues, such as natural disasters, education, and human resources development.

As for revenue mobilization, the authorities are adopting information and communication technologies (ICT) to promote electronic tax payments and improve the administration of a broad set of taxes, including road, land, VAT, and income taxes. Tax legislation is being reviewed to address possible leakages, and an MTRS has been developed with the help of the Fund's Fiscal Affairs Department (FAD).

At the same time, the authorities are determined to continue to optimize expenditures and enhance debt management capacity. The project pipeline is being reviewed to reprioritize capital spending while the public wage bill is being contained. The authorities will closely consider the advice of Directors, that this is a good opportunity to undergo a Public Investment Management Assessment (PIMA). The public debt management law was passed in 2018. The authorities are committed to its effective implementation to tighten the policies for contracting and guaranteeing public debt.

On the monetary policy and exchange rate policy, the authorities see merit in gradually introducing flexibility into the exchange rate market when preconditions have been met. The authorities are also looking to build international reserves to help fortify external buffers.

Consistent with the suggestions from Directors, the authorities are, likewise, looking at the measures to further advance improvements in the monetary policy framework and implementation, as well as to develop the financial market, especially the securities and foreign exchange markets. The authorities also put a lot of effort in promoting the use of their local currency to reduce the degree of dollarization in their financial system. The authorities have launched a Lao kip promotional campaign and are enforcing the use of Lao kip for domestic transactions. Moreover, the improvements in mobile banking services and the relative stability in the exchange rate are also expected to encourage the greater use of the Lao kip in the future.

On the financial sector, we would like to reassure Directors that the authorities are focused on making further inroads to enhancing risk-based supervision and to implement the International Financial Reporting Standards (IFRS).

On the real sector, the investment in infrastructure would play a crucial role in the diversification of Lao's economy. The authorities agree with Directors' assessment that complementary measures to improve the business environment, upgrade the skills of the labor force, promote labor participation, including of women, and enhance access to finance, in particular for the SMEs, would be vital to help transform the economy and make growth more inclusive.

The authorities also continue their efforts to improve data quality and transparency practices, and they have benefitted from various TA offerings from the Fund and their development partners.

The authorities are also committed to implement the legislation on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT). The National Risk Assessment was completed last year, which identified areas for further improvement. This has helped our authorities in their ongoing preparations for the full assessment against Financial Action Task Force (FATF) standards to be undertaken next year.

Finally, while policies are being issued and a reform road map is being laid out, the authorities recognize the challenge of effectively implementing these measures. The TA being provided by the Fund and other development partners are useful in this respect.

I would like to end my remarks by thanking Ms. Kvintradze and the rest of her team, Mr. De, Ms. Brussevich, and Mr. Adachi, for their productive and candid dialogue with the authorities. We would also like to thank Mr. Rhee, Ms. Gulde-Wolf, Ms. Song, and the Chair for their close guidance to the mission team. Our authorities appreciate their valuable policy advice and TA from the Fund and look forward to future engagements.

The Acting Chair (Mr. Furusawa) noted that Lao PDR is an Article VIII member and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Lao P.D.R.'s sustained strong economic growth, stable inflation, and progress made towards graduating from the Least Developed Country status despite challenging circumstances. Directors noted that, while the outlook for growth remains favorable, risks are tilted to the downside. They welcomed the authorities' commitment to maintaining sound macroeconomic policies and further deepening the reform agenda to reduce vulnerabilities, address structural weaknesses, and promote sustainable and inclusive growth.

Directors emphasized that gradual fiscal consolidation, supported by comprehensive public financial management reforms, is important for fiscal and debt sustainability. They noted that reorienting consolidation efforts from expenditure compression to revenue generation would be helpful to build the fiscal space needed for social development and infrastructure needs as well as to achieve the sustainable development goals. In this regard, Directors welcomed the development of a medium-term revenue strategy and encouraged the authorities to implement the strategy and to improve tax legislation and administration, as well as broaden the tax base.

Directors underscored the need to reduce risks to debt sustainability. They highlighted that effective implementation of the new Public Debt Management Law and developing debt management strategy, supported with capacity building, would help strengthen the debt carrying capacity. Directors concurred that the on-going assessment and targeting of infrastructure projects with high social returns and financing these at concessional terms, to the extent possible, would also support debt sustainability. Noting the scale of the projects, they called for further strengthening the public investment framework, continuing assessment and monitoring of fiscal risks, and actively diversifying export markets.

Directors emphasized that further efforts to modernize monetary governance and strengthen liquidity management would support reserves build-up and macroeconomic stability. In addition, improving liquidity forecasting and gradually increasing exchange rate flexibility, will also contribute to increasing international reserves. Directors highlighted that boosting productive investments to enhance competitiveness and diversification are necessary to strengthen the overall external position.

Directors agreed that financial sector reforms should focus on financial deepening and boosting resilience to risks. Implementing risk-based supervision would help identify and reduce risks, while transitioning towards the Basel II framework would help build buffers. Directors also agreed that providing guidance on forthcoming regulatory changes would improve predictability of the regulatory environment, while facilitating SME financial literacy and access to finance would support inclusive growth.

Directors noted the progress in improving the quality and timeliness of economic statistics. They encouraged bringing the monetary and financial sector indicators to regional reporting standards. Directors called for further strengthening of the AML/CFT framework in preparation for the 2020 FATF assessment.

Directors highlighted that spreading the benefits of economic growth would require consistent investment in human capital. Improving education attainment, skills training, reducing the regulatory burden on SMEs, increasing access to finance, easing trade regulations, and introducing policies that support greater participation of women in the formal economy would make growth more inclusive. Technical assistance from the Fund and development partners remains critical to support these ambitious reforms, taking into account Lao's absorptive capacity.

It is expected that the next Article IV consultation with Lao P.D.R. will be held on the standard 12-month cycle.

APPROVAL: May 29, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. ***While we see steady increase in FDI from China until 2018, we would like to know whether any early sign of FDI slowdown is observed more recently.***

- There have been no signs of a slowdown in FDI slow-down yet, but staff view it as a potential risk associated with a sharper than expected slowdown in China.

2. ***On the large investment project, such as Kunming-Vientiane railway… In this regard, could staff elaborate more on the economic impact of these projects with and without relevant reforms?***

- In general, quantitative impact assessment of various projects with or without relevant reforms would require project-specific micro data on gestation, capacity utilization, and cashflow projections, which is not accessible to staff. Conceptually, with sufficient capacity utilization projects are expected to start generating cashflows to meet future debt service requirements. To do so, infrastructure projects need to be considered within the ecosystem of integrated export market and the domestic economy. In that context, reducing regulatory burden would create more enabling environment for various business activities and would need to be complemented with skills training, SME access to finance, supporting services, secondary infrastructure, gender inclusion, and other actions (appendices IV and V, Box 1.).

3. ***Despite higher metal prices for mineral exports, and increased electricity generation, there doesn't seem to have been much increase in these exports, with their share in GDP declining between 2017 and 2018 and projected to decline further going forward. Presumably this decline reflects mining sector performance? Could staff elaborate on the reasons behind the unexpectedly weak mining export trend?***

- The downward trend of mining sector's share in total GDP and exports reflects slowdown of mining production. While the mining sector was a strong contributor to growth and exports over the decade, major mines are expected to deplete ore by early 2020s and started to decrease their production.

4. ***Could staff provide an update on the impact on the economy of the recent intensification of the dengue and swine fever epidemics as well of the drought?***

- The outbreak of dengue fever, African swine fever, infestation of sweetcorn crops and drought were among the pressing issues discussed during the government monthly meeting that need to be urgently addressed. The economic impact from the recent intensification of dengue and swine fever has not been estimated. The reported number of dengue related cases is increasing, and the African swine fever has already caused some damage in the agriculture sector. Both ailments could affect tourism. The drought could have a significant impact on the rice harvest. The lack of rain has delayed rice production in the wet-season rice fields, but the exact figures concerning damaged crops had not been reported.

5. ***As noted in the staff's report, not only the overall diversification levels remain low but also exports are expected to become even less diversified, making Lao PDR highly dependent on the demand of electricity from neighboring countries. We are less concerned about the risks from the tightening of global financial conditions due to the last developments. Staff's comments are welcome.***

- The impact from the trade channel would be prominent given the high share of electricity exports and the dependence on neighboring countries. However, several long-term power purchase agreements currently in place help mitigate risks from demand slow-down. In a longer-term, expanding and diversifying export markets is recommended to further mitigate risks. Additionally, while Lao P.D.R.'s direct integration in global financial markets is limited, the impact on the financial conditions on Thai market due to tightening global conditions is important for future rollovers and issuances for Lao PDR given their access to this market.

Fiscal Policy and Debt Sustainability

6. ***At the same time, could staff provide a detailed table with the key fiscal adjustment measures and their likely yields envisioned in the adjusted policy scenario?***

Table 1. Lao P.D.R.: Fiscal Impact of Policy Scenario Measures

	Measures	2020	2021	2022	2023	2024	2025
		Impact (percent of GDP) 1/					
Tax Revenue		**0.5**	**1.0**	**1.4**	**1.8**	**1.8**	**1.8**
Personal Income taxes	Simplify and strengthen tax administration; increase the top marginal rate; eliminate tax exemptions on capital gains.	0.1	0.2	0.2	0.3	0.3	0.3
Profit taxes	Adopt a rules-based tax incentives system, relying on expenditure-based tax incentives.	0.0	0.0	0.1	0.2	0.2	0.2
VAT	Adopt a rules-based tax incentives system; review exemptions; simplify and strengthen tax administration	0.3	0.5	0.7	0.9	1.0	1.0
Excise duties	Increase the excise tax rate on selected goods.	0.1	0.1	0.2	0.2	0.2	0.3
Other taxes	Introduce new land and property tax law.	0.1	0.1	0.1	0.1	0.1	0.1
Total Expenditure		**0.3**	**0.4**	**0.5**	**0.6**	**0.7**	**0.7**
Transfers	Increase spending on health and education.	0.2	0.2	0.2	0.2	0.2	0.2
Net acquisition of nonfinancial assets	Increase spending on social infrastructure and natural disaster mitigation.	0.1	0.2	0.3	0.4	0.5	0.5

1/ Yield is calculated as a difference between policy and baseline scenarios.

7. ***In this context, we would like to ask staff to elaborate further on the authorities' views in this regard, especially that according to the estimates fiscal consolidation requires additional revenues of 1.5 percent of GDP to achieve the policy scenario (Box 2).***

- The authorities envisage fiscal consolidation of a similar magnitude and pace with a bigger emphasis on expenditure compression. Staff, however, emphasizes the importance of preserving fiscal space for social spending and natural disaster mitigation, which would require further strengthening revenue mobilization.

8. ***We wish to highlight the importance of ensuring that the overall fiscal instrument mix chosen to effect consolidation takes into account the different elasticities of different revenue mobilization and expenditure choices, to ensure that the net effect is not regressive. If this analysis has not already been done for Lao, we wonder if assistance is available from the Fund or other development partners to help with country-specific analysis in this area? Staff comments are welcome.***

- The FAD TA team that helped design the tax policy component of the Medium-Term Revenue Strategy (MTRS) analyzed the implications of recommended tax policy reforms on progressivity of the entire tax system. Namely, the TA team recommended adoption of a more progressive personal income tax system, outlining specific rate and base changes across narrow tax categories to achieve it. In addition, the team recommended introduction of a land and residential property tax, which has minimal effect on growth, but also has features of being both efficient and progressive. While elasticities of these revenue mobilization measures were not estimated, mainly due to data constraints, the analysis was done based on understanding of Lao current tax system and international evidence. The team also analyzed the benefits of an efficiently administered VAT system, which significantly outweigh the costs in terms of progressivity of the overall tax system, if any. Finally, the proposed MTRS package considers an increase in spending on social needs, including health, education, social infrastructure and climate change-related investments. To that effect, the policy scenario developed in the SR emphasizes the need to consolidate without jeopardizing social and development spending needs. Also, considering ongoing tax automation efforts, the tax related databases are expected to become more accessible and comprehensive to conduct further scenario analysis in the future.

9. ***Given social spending needs, we would have expected the debt consolidation to be more heavily weighted towards revenue mobilization, as per the staff suggestion. Could staff comment on the authorities' rationale for the current plans to reduce the deficit?***

- The authorities understand significant vulnerabilities associated with increasing debt levels and have commenced fiscal consolidation in 2018, bringing down the fiscal deficit from 5.5 to 4.4 percent of GDP. Fiscal consolidation efforts will continue throughout 2019 mainly due to spending compression. Further fiscal consolidation plans under consideration by the authorities include spending cuts in the public wage bill and investment (refer to question 10). The authorities are also committed to adopting the MTRS in line with FAD's recommendations. The authorities are conducting a comprehensive review of the VAT tax base; rolling out electronic tax payment systems; and reviewing multiple tax laws (e.g., income law, tax management law, excise tax law). Timely implementation of these measures will ensure robust fiscal consolidation and reduction of the debt burden.

10. ***We also noted that the authorities are re-assessing their investment pipeline. Do staff have a view on timelines for this assessment and the key priorities for investment within social spending and resilience?***

- The authorities have commenced the review of the investment pipeline in 2019, which will continue at least throughout 2020. The review focuses on eliminating non-essential investment projects across all sectors. In staff's view, investment in education and health as well as spending on natural disaster mitigation are the key spending priorities, as reflected in the policy scenario (box 2.).

11. ***We welcome the development of the 2021-2025 MTRS and emphasize the importance of its timely approval and implementation. Could staff comment on the authorities' plans for the respective timeline in this regard.***

- The authorities have committed to hold a consultation on the MTRS with the National Assembly during 2020, with a final approval expected by October 2020 and implementation as of January 1, 2021.

12. ***Staff's comments on the authorities' envisaged timeline to develop a medium-term debt strategy are welcome.***

- The development of the medium-term debt management strategy is expected by end 2020 and is being supported by extensive TA under the World Bank's Lao P.D.R. green resilient growth development program operation.

13. ***Could staff elaborate on whether the authorities are considering to undertake a PIMA?***

- The PIMA is planned for 2020 in coordination with JICA. JICA is already providing TA in this direction (Appendix VII.)

14. ***We take note of the DSA result but would appreciate if staff could elaborate on the PPP shock scenario. We notably have trouble to appreciate whether such a shock is realistic given the mentioned strong track record of implementing energy exports from mega- power projects.***

- The DSA includes large contingent liabilities shock (29.4 percent of GDP) to capture risks associated with Lao P.D.R.'s large stock of PPPs. The shock is calibrated as 35 percent of the country's total PPP capital stock (85 percent of GDP – the largest amongst LICs) according to standard LIC DSF guidelines. The strong track record of the country's energy exports has been considered in the baseline and also provides the basis for sustainability argument in the customized scenario.

15. ***Often times, currency depreciation would be expected to boost export performance in the medium to long term, helping to improve debt carrying capacity and debt service indicators. Could staff comment on the relative magnitudes of these effects in Lao and elaborate on pertinent advice to the authorities?***

- In the case for Laos impact of currency depreciation on export performance is limited in the near term, given that resource (power and mining) exports constitute more than 50 percent of total exports and denominated in foreign currency. Additionally, the power sector is under long-term purchase agreements with power importers. For the long-term, the advice to authorities has been to transition away from resource driven to more inclusive growth model and diversify export markets. Utilizing technical assistance to strengthen the debt management capacity is an immediate priority and development partners are also supporting these efforts.

16. ***Can staff comment on whether there are any significant remaining debt data gaps?***

- Authorities are making efforts to strengthen their debt management capacity with significant TA support from development partners. In the context of DSA, the authorities were able to provide sector specific understandings to inform the customized scenario. However, in technical discussions, staff found that Debt Management and Financial Analysis System (DMFAS) was outdated and required an upgrade. Subsequently, staff reached out to the WB (which provides extensive TA in debt management) and highlighted the need to frontload the data management system upgrade, now expected in 2019 (appendix VII). That said, implementation of the new Public Debt Management Law and development of medium-term debt management strategy opens opportunities for strengthening the PPP framework including monitoring of indirect liabilities.

17. ***Could staff comment on whether discussions have been had with international partners and other international finance institutions to support the financing of both priorities: disaster response and resilient investment?***

- International development partners, under UN leadership, and authorities have formed a joint working group which has conducted comprehensive Post Disaster Needs Assessment (PDNA), approved by the government in 2019 (Appendix III). Going forward, the authorities and developing partners recognize the challenges to achieve multiple goals (1) creating the fiscal space to respond to future natural disasters, (2) developing resilient infrastructure, and (3) improving social protection. The UN, World Bank and other developing partners are supporting the ongoing recovery and reconstruction activities and the development of a national disaster risk financing and insurance strategy to improve financial resilience to natural disasters. The mission team had extensive consultations with the donor coordination group covering aspects of natural disaster preparedness and mitigation among other topics.

18. ***We would appreciate further comments on the efforts to build social resilience including the provision of social safety nets following natural disasters.***

- The PDNA points out that a limited safety net, which currently covers only about 17 percent of the working-age population of Lao P.D.R., is not enough to address the social needs following natural disasters and recommends that the advancement of social protection systems and safety net approaches should be strengthened. The current situation of no fiscal space in Lao P.D.R. makes the establishment of a government-funded social safety challenging without strong efforts in revenue mobilization to build up the space for spending. The WB and other development partners are supporting Lao P.D.R. in implementing disaster risk financing instruments which focus on social resilience.

Monetary, External, and Exchange Rate Policies

19. ***Staff's comments on whether the BOL is considering widening the FX trading band are welcome. Do the authorities have a long-term plan for FX market reform?***

- BOL sees the merit towards the gradual approach in increasing exchange rate flexibility. In that context, the currency continued to gradually depreciate in 2019. BOL has also agreed to improve the functioning of interbank market but has not announced commitments to specific trading bands. That said, BOL continues to monitor the buying and selling rates and developments in the parallel market premium.

20. ***We note that the authorities adjusted the reserve level considering non-FDI-related imports given that most of the FDI-related projects use their own funding which are unrelated to the international reserves at the central bank. Could staff elaborate on this adjustment?***

- The authorities assess the reserve cover using import levels adjusted for FDI-related imports given that most of the FDI-related projects use their own funding and are settled outside the country and are therefore unrelated to the international reserves held at the central bank. To do this, they subtract the FDI-related imports from total imports and then use this figure to assess reserve coverage. For example, in 2018, using the authorities' methodology total imports were adjusted down by US$ 3 billion to reach the reserve coverage of 3.2 months of imports.

Financial Sector

21. ***Could staff also elaborate further on the degree of financial dollarization in the market and how it affects FX market reform and development? (Johnston) With a highly dollarized banking system, we agree with staff that high dollarization could amplify the external risks and further effort for de-dollarization is needed. In this regard, we would like to know more about the authorities' strategies for de-dollarization and staff's recommendation on this front.***

- The FX share in credit has been stable at around 51 percent and deposit is at around 55 percent. This highly dollarized financial sector balance sheet requires the authorities to take a gradual approach in increasing exchange rate flexibility and improving the functioning of interbank market. The authorities continue to implement measures to promote the greater use of the Lao Kip and facilitate de-dollarization including a Lao Kip promotional campaign and strict enforcement of legislation on domestic transactions to be based in Lao Kip. Moreover, authorities anticipate that improvements in mobile banking services and roll out of automated payment systems will encourage the greater use of the Lao Kip.

22. ***At the same time, we note the authorities' objection to staff's recommendation to raise foreign exchange reserve requirements in order to address foreign currency lending risks. Could staff elaborate on any alternative approaches in this area? As a related matter, could staff comment on additional measures that can help reduce dollarization?***

- Authorities objection to raise foreign exchange reserve requirements in the near term was in the context of the credit growth decline. Previous staff reports cover the dollarization issue extensively and other recommendations include increasing capital buffers, conducting government transactions in Kip, ensuring convenient payment platforms, and gradual exchange rate flexibility.

23. ***We look forward to next year's full assessment against the Financial Action Task Force (FATF) standard and would welcome staff's assessment on the shortcomings on the effectiveness of the current AML/CFT regime.***

- The authorities have made significant progress in developing the legal and institutional frameworks for AML/CFT. The assessment against FATF will focus on the application of these new legal and institutional frameworks in practice which could be challenging given the ongoing process of capacity building in the AML office. The AML office has identified eight priority sectors and currently focuses on three sectors (bank, insurance and casinos). Developing standardized data reporting systems to support analysis remain a priority. The WB and some bilateral donors are assisting in the preparation of the 2020 assessment.

24. ***In 2020 Lao will have a full FATF review and implementing anti-corruption and CFT measures ahead of this should be a priority. We agree that TA from development partners should support this. Could staff comment on where conversations are on this?***

- The World Bank has supported the authorities to implement the Financial Action Task Force (FATF)'s 40 recommendations. Also, the U.S. government, together with the United Kingdom and the U.N., is providing ongoing support in low enforcement, capacity development, and information technology and equipment.

Structural Reforms

25. ***Under the World Bank Human Capital Index Lao scores 0.45 (meaning the population are realizing under half of their human capital potential) and under the***

Human Development Report on Gender Inequality Lao is ranked 109th. In comparison, Vietnam and Thailand score 0.67 and 67th, and 0.60 and 93rd respectively. Could staff comment on whether there are any policy lessons that Lao can adopt from regional partners?

- Investment in women's education and health care in Vietnam and Thailand has been at the forefront of the strategy to promote gender inclusion. These efforts have received significant support from development partners like including the WB and the UN. Significantly higher rates of adolescent pregnancies, limited access to health care and thus higher maternal mortality rates, as well as lower representation of women in managerial and official positions contribute to Lao P.D.R.'s relatively low ranking compared to Thailand and Vietnam. Lao P.D.R. needs to build significant fiscal space to catch up with its regional peers on health and education spending. Development partners are also engaged in programs to assist Lao P.D.R. in further promote gender equality.

Capacity Building

26. ***Can staff comment on plans to provide support for Lao PDR to overcome capacity constraints related to meeting its obligations on provision of data to the Fund over a realistic timeframe?***

- The BOL has completed its 2018 IIP survey in August 2018 and is repeating the survey in 2019. The first full set of IIP is expected to be disseminated internally in Laos and data are submitted to the Fund by July 2020.

27. ***In the context of the exceptionally high amount of Fund TA, could staff elaborate more on the progress made in improving the absorptive capacity of TA?***

- Good progress has been made in improving macroeconomic statistics, but much more remains to be done to improve the quality and timely dissemination of data. Lao is now a e-GDDS participant (since November 2018) and has launched a National Summary Data Page since. Annual GFS time series have been published on the ministry of finance's website for the first time in 2019. However, while there has been good progress due to these efforts, the progress has been slow due to the lack of resources and capacity constraints. Staff would like to emphasize that TA and CD remains crucial for Laos at this juncture. TA provided by other donors and international organizations in support of authorities' reform efforts and in line with IMF's past policy advice are covered in Appendix VII. Information annex also includes references to the WB and ABD country pages for more detailed coverage of their assistance.

Article IV Publication

28. ***Are staff aware of any particular concerns holding the authorities back from agreeing to publish?***

- The staff report, as staff understands, is currently undergoing an internal review process with the authorities. In previous years, the authorities have consented to publication.