**Lao P.D.R.: Assessment Letter for the Asian Development Bank and World Bank**
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1. This note provides an update of the assessment of Lao P.D.R.'s macroeconomic conditions and outlook presented at the time of the 2004 Article IV Consultation.[1]

## Economic Conditions and Outlook

2. **Macroeconomic conditions have remained stable.** The kip has strengthened to around KN 10,300 per dollar and the 12-month rate of inflation has settled into single digits (7 percent in February). External reserves have also remained at relatively comfortable levels (3½ months of imports). Staff still estimate growth at 6 percent in 2004, based upon a recovery in agriculture and hydroelectricity output and a rebound in tourism.

3. **Provided that sound macroeconomic policies are sustained, the short-term macroeconomic outlook remains favorable**. Growth is projected to rise to 7 percent driven by a sharp increase in mining output, inflation should remain in single digits, and buoyant export growth and donor inflows should facilitate a further build-up in external reserves in 2005. This positive outlook is contingent upon the implementation of steps discussed below to strengthen the 2004/05 budget and contain credit expansion at the state banks.

4. **The staff's medium-term outlook is broadly unchanged from that reported at the time of the 2004 Article IV Consultation**. With a number of major foreign projects in the pipeline, Lao P.D.R. has the potential to sustain robust economic growth and achieve significant reductions in poverty, provided that progress is made on structural reform. In this regard, further advances in revenue mobilization, and banking and state-owned enterprise reforms, will be particularly important, given the risks to fiscal sustainability. Given Lao P.D.R.'s high public debt burden, prudent debt management, including by ensuring a high degree of concessionality on any new loans, will also be important.

## Recent Policy Developments

5. **The staff have urged the authorities to revise the 2004/05 budget plan approved by the National Assembly last October**. The staff's principal concerns were that the revenue target (12.2 percent of GDP) was overambitious, especially in view of a number of

[1] The 2004 Article Consultation was concluded on November 29, 2004. The staff report and accompanying papers are available on the IMF's public web site.

adverse developments,[2] and given the revenue prospects the large increases in wages and allowances proposed in the budget plan were not sustainable. To address these risks, staff have proposed that the 2004/05 budget be based upon a more achievable revenue target (11.4 percent of GDP) and that the increase in wages and allowances be limited (to 20 and 30 percent, respectively) to contain the growth in wage expenses to sustainable levels. The authorities have indicated that they intend to submit a revised budget to the National Assembly in April 2005 that is broadly in line with the staff's recommendations and seek approval at that time of a package of tax measures that will include the reform of the turnover tax. Adoption of the revised budget by the National Assembly and its effective implementation will be essential for safeguarding macroeconomic stability.

6. **Staff have proposed a monetary framework for 2005 that aims to consolidate the recent decline in inflation.** Under the framework, the central bank's net domestic assets would decline gradually over the year to accommodate a build-up in international reserves to around 4 months of imports. In addition to fiscal discipline, monetary stability in 2005 hinges on tight control over credit growth at the state banks. While credit expansion moderated somewhat in the fourth quarter of 2004, these banks remain vulnerable to pressures to extend credits on a noncommercial basis. In addition to retaining tight limits on the expansion of state banks' net domestic assets, the staff have urged the authorities to strengthen the regulatory regime governing the extension of credits, particularly with regard to single borrower exposures. The authorities are working on the revised regulations with the assistance of a Fund banking supervision expert.

7. **There is a need to accelerate structural reforms, particularly in the fiscal area.** Prompt implementation of a number of outstanding reforms will be key in this regard.

- Only limited progress has been made in recent months in advancing revenue reforms. A recent government instruction assigning responsibility for tax and customs operations to the provinces has been a setback, although the regulations clarify that the center will retain a supervisory role.

- The customs department has made progress in strengthening its oversight of the largest customs posts and the authorities have indicated that they plan to submit a new customs law—broadly consistent with advice provided by the Fund—to the April 2005 session of the National Assembly. Reforms at the tax department are proceeding slowly, although some steps have been taken, assisted by SIDA, to prepare a plan for the implementation of the VAT.

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[2] These include a delay in approval of key revenue measures, such as the restoration of a two-rate turnover tax, a decision to suspend the excise on diesel (since partially reversed), and slower-than-expected progress in reforms to strengthen tax and customs administration.

- The new investment laws passed by the National Assembly last October are broadly consistent with understandings reached with staff. However, initial drafts of these laws' implementing regulations lack a number of key provisions, including with respect to strengthening the Ministry of Finance's control over the administration of tax incentives, and protecting the future VAT from tax exemptions.

- Some progress is being made in the operational reform of the state banks, but the process of recapitalizing the state banks and implementing their governance agreements, especially with regard to the credit management procedures, has been more problematic.[3] Draft amendments to the banking law to strengthen competition in the banking system have been finalized and forwarded to the National Assembly for its approval.

- In addition, the outstanding issues regarding the Fund's safeguards policy remain unresolved. Staff were not able to reach understandings on the compromise proposal to commission a targeted review of the central bank's external reserves and reserve money, by an international audit firm.

**Status of Fund Relations**

- Lao P.D.R.'s PRGF arrangement with the Fund (SDR 31.7 million) was approved in April 2001. To date, three reviews have been completed with SDR 18.1 million disbursed (the third review was completed in September 2003). Completion of the fourth review has been delayed due to slow progress on structural reforms and outstanding issues related to the Fund's safeguards policy. The arrangement is due to expire on April 24, 2005 and no further disbursements are expected before that date.

- The Fund expects to remain engaged in a close policy dialogue with the authorities after the arrangement expires. To this end, Fund staff plan to undertake two missions to the Lao P.D.R. this year, one of which will coincide with the annual Article IV Consultation. Fund staff have agreed to provide assessment letters to the World Bank, and other donor partners, after each of these missions.

[3] In particular, there have been a number of cases where the banks' procedures were overriden, resulting in loans being extended in breach of sound lending principles.