

Lao People's Democratic Republic—Staff Report and Public Information Notice

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2010 Article IV consultation with Lao People's Democratic Republic, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 15, 2010, with the officials of Lao P.D.R. on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 14, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff supplement on the joint World Bank/IMF debt sustainability analysis.
- A Public Information Notice (PIN).

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LAO PEOPLE'S DEMOCRATIC REPUBLIC

Staff Report for the 2010 Article IV Consultation

Prepared by the Staff Representatives for the 2010 Article IV Consultation
with the Lao People's Democratic Republic

Approved by Masato Miyazaki and Dominique Desruelle

July 14, 2010

Mission: Discussions were held in Vientiane during June 2–15, 2010. The staff team met with Prime Minister Boupnavanh, Bank of Lao P.D.R. Governor Khamphounvong, Deputy Minister of Finance Ms. Siphandone, and other senior officials. The team also met with private sector representatives, donors, and the press.

Team: Mr. Almekinders (Head), Mr. Ree, Ms. Maslova (all APD), assisted by Mr. Bingham (Senior Resident Representative), Mr. Ngaosrivathana (country manager), and Ms. Nanthavong and Ms. Nga (country economists). Ms. Vongpradhip and Mr. Phan (both OED) participated in the meetings.

Focus: Discussions centered on (i) short-term challenges posed by pressures on the balance of payments caused by the sharp increase in public investment and rapid credit growth of the past two years; and (ii) the longer-term challenge of sustaining Lao P.D.R.'s strong growth performance that will be addressed in the government's forthcoming five-year plan (2011–15).

Past surveillance: Directors' views expressed during the 2009 Article IV Consultation, completed on July 10, 2009, can be found in IMF Country Report No. 09/284. The government's September 2009 decision to stop direct central bank lending to local governments and the resulting fiscal tightening were in line with Directors' advice. Directors' call for a tightening of monetary policy has so far not been acted on.

Exchange regime: The de jure regime is a managed float. The de facto regime is stabilized. On May 28, 2010, Lao P.D.R. accepted the obligations under Article VIII, Sections 2, 3, and 4 (Press Release no. 10/298).

Statistical issues: Serious data shortcomings that hamper surveillance, with the balance of payments and the national accounts most in need of strengthening.

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Executive Summary

Economic Developments

The Lao P.D.R. economy performed well in 2009, despite the global crisis. Growth, at 7.6 percent, exceeded the average of low-income countries in the region and inflation remained below the regional average. Growth was supported by rapid expansion of the mining and hydropower sectors and expansionary fiscal and monetary policies.

However, the economy continued to exceed its macroeconomic “speed limits,” putting pressure on the balance of payments:

- The fiscal deficit rose 4.4 percentage points to 7.2 percent of GDP in FY09 (October 2008–September 2009) propelled by large extra-budgetary investment outlays financed by direct lending from the central bank to provincial governments. In September 2009, the government decided to stop such direct central bank lending. Disbursements on existing loan commitments have continued but are expected to be phased out by September 2010, contributing to a fiscal tightening.
- Credit to the private sector continues to grow very rapidly (87 percent y/y in March 2010), driven by the rapid development of the banking system in recent years and accommodative monetary policy.

The central bank continues to operate a stabilized exchange rate regime. The acceleration in the growth of domestic demand and imports related to the expansionary macroeconomic policies have resulted in a decline in banking system net foreign assets which have fallen from US\$1 billion in May 2008 to US\$670 million in March 2010. Inflation remains relatively contained at 4.9 percent, but real estate and land prices appear to be rising rapidly.

Outlook and Policy Issues

The outlook for GDP growth in 2010 is favorable, but central bank reserves are projected to decline in the absence of further efforts to rein in credit growth, posing risks to external and macroeconomic stability. The projected narrowing of the fiscal deficit to 4.9 percent of GDP in FY2010 would make an important initial contribution to the needed policy tightening. Inflation is likely to remain moderate provided the exchange rate remains stable.

Lao P.D.R.’s medium-term prospects are promising, provided that macroeconomic stability is maintained and progress continues to be made in (i) efforts to strengthen the soundness of the financial system; and (ii) reforms to strengthen the competitiveness of the economy. The legal and regulatory reforms that would accompany WTO membership would greatly assist this process.

The authorities were in broad agreement with the staff’s assessment on the need for a policy tightening and indicated that they would look for ways to balance the government’s support for growth with macroeconomic stability considerations. Concerns about possible spillovers from the sovereign debt problems in Europe were cited as a reason for additional vigilance. The authorities agreed on the need to improve the monitoring of the quality of credit and noted that they would henceforth look at a broader array of indicators of reserve adequacy.

I. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

1. **Lao P.D.R. weathered the global crisis well in 2009.** Although the crisis did have an impact on exports, nonregional tourism, and capital inflows, GDP growth held up very well, at 7.6 percent, one of the highest in the region. Growth was buoyed by ongoing projects in the mining and hydropower sector, as well as the boost to construction and other sectors provided by a sizable fiscal expansion, an accommodative monetary policy and one-off events such as the South-East Asia games that were held in Vientiane in December 2009.

2. **However, the economy continued to exceed its macroeconomic “speed limits” in 2009, putting pressure on the balance of payments.** Although inflation remains relatively contained at 4.9 percent, prices of real estate and land have been rising rapidly and an acceleration in the growth of domestic demand put pressure on the external position. Gross international reserves of the Bank of Lao P.D.R. (BoL) remained relatively stable at around US\$630 million, thanks to the SDR allocation from the IMF (US\$65 million) and sales of U.S. dollar-denominated BoL securities to domestic banks (US\$43 million). However, gross reserves now cover less than 80 percent of reserve money liabilities, down from 150 percent, on average, during 2000–08 (Table 4). Net foreign assets (NFA) of the banking system fell by a further US\$215 million in 2009. With gross foreign assets of the banking system now covering only 51 percent of banking system liabilities, the liquidity buffer to absorb external and internal shocks is now substantially less comfortable than during 2000–07 (Box 1).

3. **The pressure on the balance of payments in 2009 stemmed primarily from expansionary macroeconomic policies.** The overall fiscal deficit widened by 4.4 percentage points of GDP to 7.2 percent of GDP in FY09, mainly because of a sharp increase in off-budget spending (4 percent of GDP), funded mostly by loans from the BoL to provinces to finance infrastructure projects, including for the South-East Asia Games and the celebration of the 450th anniversary of Vientiane. Monetary policy was also expansionary, with the growth of credit to the private sector rising further to 88 percent in 2009. While the bulk of the new credit continued to come from the state-owned commercial banks (SOCBs), credit growth by the smaller private banks was also very rapid, exceeding 100 percent in some cases. While the expansionary policies did support growth, the boost to domestic demand resulted in a widening of the nonresource current account deficit from 6 to 12 percent of GDP between 2007 and 2009. With FDI inflows slowing during this period, due to delays and postponements in mining and hydropower projects in the aftermath of the global crisis, this widening in the current account deficit resulted in the decline in banking system NFA noted above.

4. **The outlook for GDP growth in 2010 is favorable and inflation is likely to remain moderate.** Growth is projected to remain close to 8 percent, supported by a continued expansion in the mining and hydropower sectors, a rebound in nonresource exports and tourism, and continued strong domestic demand. The start of commercial operations of

Box 1. Measures of Reserve Adequacy

According to a commonly-used rule of thumb, a country's central bank should have sufficient gross reserves to pay for three months of imports of goods and services to cope with the eventuality of a sudden stop in balance of payments inflows.

The BoL estimates that its gross reserves covered 5.4 months of current-year imports at the end of 2009. However, the customs data used by the BoL may underestimate imports. For instance, exports from Thailand to Lao P.D.R., as reported by Thai customs, exceed total imports reported by Lao P.D.R.'s

customs. In light of this, staff continued the practice adopted in previous staff reports of using partner-country trade data from the IMF's *Direction of Trade Statistics*. Staff adds estimates of nonfactor services imports; it deducts imports of goods by the resource sectors; and it expresses reserves in months of next-year imports.

In a partially dollarized economy like Lao P.D.R., the concept of the import coverage of reserves is not as meaningful. With large amounts of foreign exchange going around in the economy, the onus will not be solely on central bank reserves in case of a sudden stop in balance of payments inflows. In that case, reserves at less than three months of imports is not necessarily problematic. It should be noted that gross reserves are equivalent to 227 percent of short-term external debt on a remaining maturity basis (116 percent if short-term trade credit—assumed at 10 percent of imports of goods and services—is included).

It would be more important to monitor the extent to which banking system liquid gross foreign assets provide adequate coverage of the liabilities of the BoL and the banks. In a dollarized economy, the demand for domestic currency is more prone to instability and banking system vulnerabilities could be a compounding factor. However, unlike what was the case during 2000–08, BoL gross foreign assets now fall short of reserve money (Table 4). Also, banking system liquid gross foreign assets have been on a declining trend since early 2008, and now only cover currency in circulation (CIC) plus about 35 percent of bank deposits (see chart).

	2006	2007	2008	2009
BoL calculation				
Gross reserves of the Bank of Lao P.D.R.	336	536	636	632
Imports of goods (c.i.f.) 1/	1,060	1,065	1,403	1,414
Gross reserves in months of current-year imports	3.8	6.0	5.4	5.4
IMF staff calculation				
Gross reserves of the Bank of Lao P.D.R.	336	536	636	632
Imports of goods 2/	(1)	1,652	2,108	2,720
Imports of nonfactor services 3/	(2)	62	76	83
Imports of goods by the resource sectors 4/	(3)	381	598	641
Relevant imports of goods and services (1)+(2)-(3)	1,333	1,586	2,272	2,343
Gross reserves in months of current-year imports	3.0	4.1	3.4	3.2
Gross reserves in months of next-year imports 5/	2.5	2.8	3.3	2.8
Memorandum item:				
Imports from Thailand 6/	1,017	1,311	1,776	1,643

1/ Source: Customs and Ministry of Commerce of Lao P.D.R.

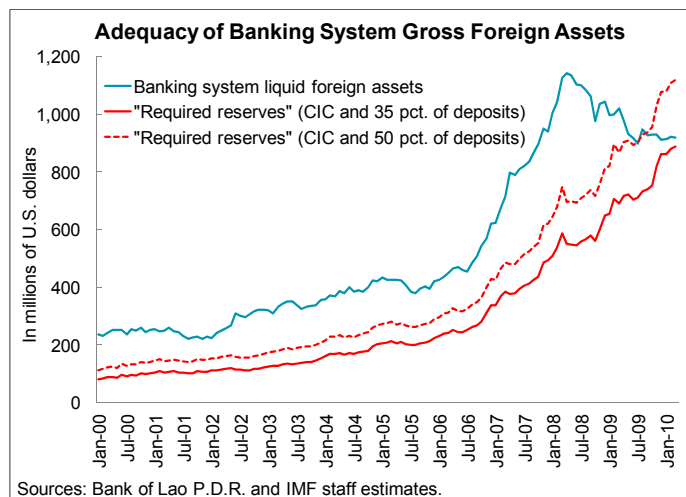
2/ Source: *Directions of Trade Statistics*, IMF.

3/ Source: BoL. Travel data is taken from Lao National Tourism Administration.

4/ Source: IMF staff's estimates based on plans of the resource sectors.

5/ For 2009, based on projected 2010 imports of goods and services of US\$2,672m.

6/ Source: Thai customs.



the Nam Theun II hydropower project in March 2010 will support growth and is expected to be an impetus for further development of the country's hydropower potential. Inflation could rise further in the next few months because of base effects, but is expected to recede to 5½ percent by the end of the year.

5. **But pressures on the external position are likely to continue in the absence of further efforts to rein in credit growth.** While the overall fiscal deficit is projected to narrow to 4.9 percent of GDP in 2010 (see paragraph 11), private sector credit is projected to exceed 50 percent in 2010 in the absence of further measures to reduce credit growth to the government's target of about 25 percent. Net foreign assets of the banking system strengthened somewhat during the first quarter of 2010, following a large mining profit tax payment in March. However, with credit expanding at the current pace, staff project that NFA would decline to just over US\$500 million by end-2010. At this level it would cover only 67 percent of reserve money and 23 percent of broad money. Moreover, unlike in 2009, when BoL gross reserves were boosted by the one-off SDR allocation and the sale of foreign currency BoL securities, which have now been discontinued, the decline in NFA would fall increasingly on BoL gross reserves, which staff project would fall to about US\$556 million in the baseline.

6. **Lao P.D.R's medium-term prospects are promising, provided that macroeconomic stability is maintained and structural reforms continue.** The recovery of copper prices and strong demand for electricity in neighboring countries are bringing forward expansion plans in the mining and hydropower sectors, which were delayed in the wake of the global crisis. Activity outside of the mining and hydropower sectors is also projected to pick up, although this will need to be supported by continued reforms to strengthen the foundation of the economy (see Section III). Nevertheless, the draft seventh five-year plan (2011–15) is very ambitious, targeting annual average growth of 8 percent, and care will need to be taken that the pursuit of this target, and the associated target of maintaining investment at 30 percent of GDP, is consistent with the outlook for FDI and concessional funding sources, to avoid risks to macroeconomic and external stability.

Lao P.D.R.: Medium-Term Macroeconomic Framework, 2007–15									
	2007	2008	2009	2010	2011	2012	2013	2014	2015
		Est.				Proj.			
Real GDP growth	7.8	7.8	7.6	7.7	7.5	7.3	6.4	7.6	9.3
Real GDP growth excluding resource projects	5.0	6.5	5.3	6.2	6.3	6.4	7.3	7.2	7.5
Consumer prices (end-period)	5.6	3.2	3.9	5.5	5.7	5.2	4.1	3.5	3.5
Overall fiscal balance (percent of GDP)	-2.7	-2.8	-7.2	-4.9	-2.4	-1.3	-1.5	-1.8	-1.9
Current account balance (percent of GDP)	-15.9	-18.5	-17.6	-10.2	-13.6	-15.4	-19.9	-25.8	-19.9
Resource current account balance	-10.1	-8.4	-5.0	3.9	0.9	-0.5	-3.5	-7.4	-0.7
Nonresource current account balance	-5.8	-10.2	-12.5	-14.1	-14.5	-14.9	-16.4	-18.5	-19.2
Gross official reserves									
In millions of U.S. dollars	528	636	632	555	551	699	823	993	1,168
In months of imports of goods and nonfactor services, excluding imports associated with large projects	2.8	3.3	2.8	2.0	1.8	1.9	1.9	2.3	2.7

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.

7. **The seventh five-year plan will need to take into account a number of potential risks to the medium-term outlook.** Specifically, on the external side, the global economic outlook remains uncertain. The outlook for Asia is promising, but the sovereign debt problems haunting many developed countries could slow the global recovery and have negative spillover effects. The uncertainty could also weigh on the price of copper and hold back FDI inflows. The five-year plan will need to take steps to guard against potential internal risks, including (i) to macro and external stability, if the pursuit of the growth targets leads to over-expansionary macroeconomic policies; (ii) to the efficiency of public investment, if the prioritization and transparency of project selection does not improve; and (iii) to the soundness of the financial system, if reforms aimed at strengthening the bank supervision are not accelerated. Finally, the achievement of the plan's ambitious growth targets rests on the implementation of deep structural reforms which could prove challenging.

8. **The staff's updated debt sustainability analysis (DSA) suggests that Lao P.D.R. continues to have a high risk of debt distress.** Prudent foreign borrowing amid strong economic growth, and an ongoing real appreciation of the kip, has put the external debt to GDP ratio on a declining path both in face value and in net present value terms. However, under the baseline scenario, two of the three external debt stock indicators continue to exceed policy-dependent indicative threshold levels over the medium term. And debt vulnerabilities are higher under the alternative scenarios and stress tests. Reflecting the high level of concessionality of Lao P.D.R.'s external debt, external debt service indicators do not breach relevant policy-dependent thresholds under the baseline scenario and also do not breach the thresholds under the stress tests.

9. **The rapid expansion of the number of banks in Lao P.D.R. and the rapid growth of credit in some banks poses risks.** Reported NPL ratios remain low, but experience in other countries has shown that NPL ratios tend to rise only during the later stages of a credit boom. Capitalization of the three state-owned commercial banks remains below the prudential limits. Collectively, commercial banks are maintaining a net long position in foreign exchange of about 2 percent of GDP and some banks are exceeding the prudential limits on the net open position. And currency mismatches in the nonbank private sector may be substantial with many borrowers in foreign currency lacking foreign currency income.

II. MACROECONOMIC POLICY DISCUSSIONS

10. **Discussions centered on policies required to maintain near-term macroeconomic stability and stem the decline in NFA of the banking system,** including by keeping the overall fiscal deficit on a consolidation path and by reducing the growth of credit to the private sector. Discussions also covered longer-term policies to support growth through strengthening the soundness of the financial system, and improving the business climate and trade integration.

A. Fiscal Policy

11. **The projected fiscal consolidation in FY2010 seems appropriate.** As noted above, staff projects the fiscal deficit to narrow to 4.9 percent of GDP in FY2010. This presumes a continuation of the strong revenue collection observed during the first half of the fiscal year, which would push domestic revenue to 15.5 percent of GDP (from 14.9 percent of GDP in FY2009). It presumes that total on-budget spending is broadly in line with the original budget plan—to which the authorities are firmly committed. And it assumes that direct loan disbursements from the BoL to local governments are phased out—in line with the decision not to enter into new lending commitments from September 2009 onward. Accordingly, and taking into account that the BoL disbursed about 2 percent of GDP during the first six months of FY2010, off-budget capital spending is projected to decline to about 3.1 percent of GDP in FY2010, down from 4.1 percent of GDP in FY2009.

12. **Staff noted that the overall fiscal deficit should be put on a medium-term consolidation path,** building on recent revenue gains and the phasing out of off-budget spending, while strengthening expenditure management. Staff noted that given the strong growth of credit to the private sector, the large public debt, and in support of the stabilized exchange rate regime, the overall fiscal deficit including grants should not exceed concessional external financing (net), which is projected at about 2.4 percent of GDP in FY2011. Recourse to nonconcessional foreign financing should be strictly limited to viable projects. Staff made several suggestions on how to achieve the needed fiscal consolidation while striking a balance with the authorities' objective to support growth. For the most part, these build on reforms that have already been initiated:

- Staff welcomed the government's September 2009 decision to stop new BoL lending to local government outside the budget for infrastructure projects. It called for all (infrastructure) development projects to be brought on the budget. Staff welcomed the government's ongoing campaign to prioritize these projects to bring them in line with available financing.
- Staff encouraged to further articulate the plans to repay the BoL loans through the central government budget starting with the FY2011 budget. It indicated that the strengthening revenue performance would provide room for doing so without crowding out key social expenditure programs. Staff noted that the BoL loans to local governments could also be repaid using the proceeds from Treasury Bonds issuance timed to coincide broadly with the amortization payments to the BoL. Staff's medium-term fiscal projections implicitly assume this. This could contribute to mopping up banks' excess liquidity and develop the government bond market. The authorities noted that repayments to the BoL from the central government budget had already started on a small scale.
- Staff and the authorities concurred that the introduction of the VAT needs to be completed by increasing the number of registered companies that file VAT returns,

by continuing to educate tax payers and the public about the VAT, and by strengthening auditing and enforcement. Tax administration reforms, including the issuance of unified tax payer identification numbers, need to be furthered by addressing capacity constraints. The VAT law denies refunds to natural resources companies, including mining companies. The mining companies refuse to pay VAT on their invoices on the grounds that their operations are subject to specific contracts that set out the taxes they pay and VAT is not part of those contracts. To further VAT implementation, staff recommended that the authorities clarify the treatment of natural resources companies under the VAT law to the companies, their suppliers, and the tax collectors and auditors.

- Staff welcomed the important progress that has been made in modernizing and strengthening the national treasury function, particularly steps toward introducing a treasury single account (TSA) system. It called for expeditious full implementation of the TSA, given that this could also contribute to a policy tightening by scaling down government deposits in commercial banks.

B. Monetary and Exchange Rate Policy

13. **Staff welcomed the intention to reduce the growth of credit to the private sector, but urged the authorities to underpin this objective with concrete measures** (Box 2). Staff noted that the target to reduce credit growth to 25 percent by end 2010 was welcome, but could be hard to achieve given strong private credit growth during the first quarter of 2010. Tentative staff calculations suggest that a deceleration of the growth of private sector credit to 33 percent, everything else equal, could be sufficient to stabilize banking system NFA during 2010. However, banks still have considerable excess reserves and it is as yet unclear how even this adjusted target for the deceleration of credit growth would be achieved. Staff suggested to the BoL to take a multi-pronged approach involving raising reserve requirement, signaling a policy tightening by raising the policy rate, and through moral suasion. The authorities indicated that they would favor using moral suasion rather than “taxing” the banking system more through higher reserve requirements. The authorities took note of the staff’s recommendation to consider also using prudential curbs, particularly for the private banks and branches of foreign banks whose lax lending standards cause their loan portfolios to grow excessively.

14. **Staff welcomed the BoL’s plans to step up efforts to sell kip-denominated BoL securities** to offset the stimulus from remaining loan disbursements to local governments. Indeed, the sales of BoL securities could be expected to force banks to start drawing on their reserves held with the BoL and push down reserve money growth (Table 4). To enhance the attractiveness of these securities, consideration should be given to raise their interest rates. Staff also welcomed the BoL’s decision, taken earlier in the year, to henceforth refrain from selling U.S. dollar-denominated BoL securities to domestic banks.

Box 2. Credit Booms Around the World: Lessons for Lao P.D.R.?

Financial development has long been identified as a key determinant of economic growth. Accordingly, a healthy rate of credit growth spurs financial deepening and economic growth by channeling increasing amounts of savings to viable productivity-enhancing investment projects. But excessive credit growth—together with a loosening of credit standards—can be a source of concern and credit booms have been the cause of financial distress in emerging markets in past decades. Historically, about 20 percent of credit booms have ended in a crash. For instance, Chapter 4 in IMF Country Report No. 06/19 found that, for a sample of 73 countries for the period 1980–2002, out of 150 credit booms identified, about a fifth (31) preceded systemic banking crises, with that proportion rising to about a third (47) if minor episodes of financial distress were included. Experience has shown that longer-lasting and more-pronounced booms have a higher chance of leading to a crash. Accordingly, countries experiencing credit booms have resorted to a broad array of measures to reduce macroeconomic and credit risks (see e.g., WP/05/128 and WP/05/151). Macroeconomic measures included fiscal tightening, raising reserve requirements, introducing liquid assets requirements, and moving government deposits to the central bank. Prudential measures included raising and differentiating capital requirements, differentiating loan classification and provisioning requirements, enforcing regulations on providing foreign currency-denominated loans only to those with foreign currency income or hedges, and tighter net open position limits for banks. Other measures included more intensive surveillance and onsite/offsite inspections, developing and deepening domestic government securities markets—to provide alternative assets for banks, and establishment and/or strengthening of credit registries.

Lao P.D.R.'s ongoing credit boom can be partly attributed to a catching-up process. For instance, the government only recently started paying out wages through the banking system, boosting the number of bank accounts and the level of intermediation. The credit boom coincides with large capital inflows but these inflows are heavily concentrated in mining and hydropower investments that are for the most part not intermediated through the banking system. While inflation remains moderate, there are signs that prices of land and real estate have risen rapidly in recent years. Given also the association with a construction boom, it would be important to reinforce the prudential framework for credit risk.

	Private Sector Credit (in percent of GDP)					GDP per Capita (US\$, 2008)	Credit Growth (avg. 2008–09, in percent)
	1990	2000	2007	2008	2009		
Malaysia	105	137	114	112	130	8,118	10
Thailand	83	108	92	94	96	4,108	6
Fiji	33	31	45	48	49	4,075	9
China	87	112	111	104	130	3,404	24
Indonesia	43	21	25	27	25	2,238	19
Sri Lanka	19	28	33	29	24	1,972	1
Mongolia	0	4	42	39	34	1,940	5
Philippines	20	45	32	34	35	1,851	12
Papua New Guinea	29	16	21	26	31	1,293	30
Vietnam	1	35	93	91	114	1,042	33
India	35	37	55	58	60	1,021	18
Lao P.D.R.	1	8	7	10	18	849	80
Cambodia	1	6	18	22	24	825	31
Bangladesh	16	22	33	35	37	523	20
Nepal	12	29	42	46	51	455	28

Sources: Lao P.D.R. authorities; CEIC Ltd.; Haver Analytics; and IMF staff estimates.

15. **Staff believes that the kip is overvalued (Box 3), but that a stabilized exchange rate regime remains the appropriate monetary anchor for Lao P.D.R.** The BoL has only a few monetary policy instruments and financial market development is still at an early stage. In light of this, a stabilized exchange rate regime remains appropriate. Staff noted that experience in Lao P.D.R. and many other countries around the world has shown that currency pegs and near-pegs are associated with a higher risk of financial crisis and slower

and more abrupt external adjustment. In light also of the pressures on the balance of payments, this makes it all the more important to implement consistent fiscal and monetary policies. The authorities were in broad agreement with the exchange rate assessment. They were more optimistic about the outlook for the balance of payments and central bank reserves based on data on FDI commitments and the expected boost from increased electricity exports to Thailand. The authorities pointed out that the parallel exchange rate remained very close to the market rate. They confirmed their objective to limit currency fluctuations vis-à-vis major currencies within ± 5 percent per annum and indicated that they would not contemplate greater exchange rate flexibility, as this could undermine the gains in reducing dollarization and fan inflation.

C. Financial Sector Issues

16. **Financial sector reforms have shown results, but further steps are needed to contain risks.** The restructuring program for the SOCBs, which continues for one of the three banks, is showing results. Progress has been made in strengthening their capitalization, governance, internal controls, and risk management. The SOCBs' improved financial position has revived their intermediation activity. With the implementation decrees for the commercial banking law now issued, the institutional framework for banking supervision has significantly improved. Good progress is being made in preparing for the October 2010 evaluation by the Asia-Pacific Group on Money Laundering Activities.

17. **But the rapid expansion of the number of banks and the high credit growth in many private banks poses risks to the future health of the banking system.** Staff commended the BoL's recent decisive handling of an emerging run on one of the newer private banks in May. But it noted that the recent events were indicative of the risks introduced by the rapid development of the banking sector in recent years, and that these risks called for accelerated progress in upgrading the level of bank supervision in Lao P.D.R. In this context, staff underscored that a "box-ticking" approach when licensing and supervising banks may sow the seeds for a rise in NPLs down the road. Instead, banks' lending standards should be scrutinized and a tightening of these standards should be mandated, if deemed necessary. Similarly, strict due diligence over (new) bank licensing should be carried out, including by the BoL's Financial Intelligence Unit. And loan classification and provisioning should be rules-based rather than subject to negotiations with the BoL. Staff suggested that the authorities consider raising the collective provisioning requirement. The present rate of 0.5 percent is low, given the strong growth of credit amid untested credit-risk assessment and credit-risk management frameworks. The legacy of directed lending is likely to make it difficult to put in place banking sector practices in line with international practice. Staff cautioned about potential risks related to linkages between banks and the developing service and entertainment sector (e.g., casinos). The authorities took note of the staff's recommendations. They noted that NPLs remain low and that onsite and offsite inspections take place regularly for all banks in Lao P.D.R. They looked forward to the assistance from AsDB-financed short-term experts to help strengthen banking

Box 3. Is the Level of the REER Appropriate?

The outlook for exports remains broadly favorable despite the recent appreciation of the kip. The REER is now 17 percent more appreciated than the 2007 average (Figure 1), owing to large foreign inflows into the mining and hydropower sectors through mid-2008 and the authorities' subsequent maintenance of a stable exchange rate of the kip vis-à-vis the U.S. dollar despite downward pressures on the balance of payments. In the aftermath of the global recession, Lao P.D.R.'s exports held up relatively well compared to other Asian countries (Figure 5). However, they appear to have benefited less from the recovery in global trade during the second half of 2009. Exports of electricity to Thailand will receive a boost from the start of operations of the Nam Theun II hydropower plant.

Estimates of Overvaluation of the Kip

Approach	Estimated Overvaluation (In percent)
Purchasing power parity	6
Macro balance	34 to 69
Equilibrium exchange rate	1
External sustainability	24 to 48

Source: IMF staff estimates.

The exchange rate assessment suggests that the kip's REER is overvalued, but two of the four approaches used for the assessment are likely to overestimate the kip's misalignment as they do not properly take into account that the projected large current account deficits are related to high FDI-financed imports.

Application of four quantitative approaches suggests that the REER is stronger than implied by macroeconomic fundamentals. In the case of the macro balance (MB) approach and the equilibrium real exchange rate (ERER) approach, the assessment involved using a large panel dataset covering more than 100 countries. The four approaches are described in more detail for the case of Bangladesh in Chapter II in IMF Country Report No. 10/56. The degree of misalignment varies from 1 to 69 percent depending on the method used. Using the CGER-based trade elasticity for Lao P.D.R. (0.19) suggests that the kip is overvalued by 48 and 69 percent when applying the external sustainability (ES) and MB approaches, respectively. However, applying a Lao P.D.R.-specific trade elasticity (0.38) suggests that the kip's overvaluation is considerably smaller. The latter elasticity takes into account (i) the composition of Lao P.D.R.'s exports; (ii) incomplete pass through of changes in exchange rates and international prices to import and export prices; and (iii) Lao P.D.R.'s price-taking behavior on international markets. The MB and ES approaches are likely to overestimate the kip's misalignment as they do not explicitly account for Lao P.D.R.'s stage in the investment cycle. The large current account deficits are related to imports for investments, including in the mining and hydropower sectors, which are financed by FDI. Foreign direct investment inflows are projected at about 18 percent of GDP in 2015 (Table 2). Assuming an import content of 60 percent, the current account deficit excluding FDI-financed imports would be only about 2 percentage points of GDP higher than the current account norm according to the MB approach. Accordingly, the kip would be overvalued by 5 percent. Moreover, once completed, the predominantly export-oriented projects would result in higher exports, reducing the current account deficit.

The overvaluation of the kip underscores the importance of tighter fiscal and monetary policy alongside structural reforms aimed at improving the business climate and trade integration with a view to narrowing the nonresource current account deficit over the medium term.

supervision, supervision of microfinance institutions, and the Anti-Money Laundering framework. They also inquired about possible assistance that the Fund might be able to provide to improve bank supervision. In response, staff indicated that the Fund would be able to provide technical assistance to the BoL in this area, and also suggested that in view of the recent rapid developments of the financial sector in Lao P.D.R. it might be an opportune time to request an FSAP.

18. **Staff called on the authorities to articulate plans to complete the recapitalization of the SOCBs.** Capital adequacy of the three SOCBs has increased but remains below the regulatory minimum. Staff recommended to link the recapitalization plans with memoranda of understanding that would lay out structural conditions and performance criteria for disbursing capital, as was the case with the expired Governance Agreements. Staff also encouraged the authorities to continue with the independent audits of SOCBs. Staff welcomed the prohibition on bank supervisors from taking positions in commercial banks within two years of leaving the BoL, as this represents an important safeguard for supervisors' independence. However, it would be important that this prohibition is strictly enforced.

19. **Staff recommended to the BoL to start enforcing the existing prudential regulations that (i) limit banks' net open foreign currency position (NOP); and (ii) prohibit bank lending in foreign currency to borrowers without foreign currency income.** Discussions between staff and some of the private banks suggested that this should be phased in gradually with assets and liabilities currently on banks' balance initially grandfathered. If enforced consistently across all banks, a considerably larger share of new loans would be denominated in domestic currency. In conjunction with enforcement of NOP limits, this would in turn encourage banks to vie more aggressively for kip deposits. This would cause banks to offer higher interest rates on kip deposits and offer to buy their customers' foreign currency, which they would subsequently sell to the BoL to observe the NOP limit. Staff noted that this would need to be supported by assurances about easy availability of foreign currency for the banks and their customers. The authorities took note of the staff's view that enforcement of relevant regulations could be expected to limit the drain on NFA of the banking system and would be consistent with the BoL's de-dollarization policy.

III. STRUCTURAL REFORMS AND OTHER ISSUES

20. **Efforts to improve the business climate and trade integration should be intensified.** Cross-country surveys conducted by several organizations (e.g., the World Bank, Transparency International) suggest that more needs to be done to make tangible progress in streamlining procedures and strengthening policy frameworks to boost private sector-led growth. The pace of reforms should be accelerated, in view also of the phased mandatory reduction of tariffs under the ASEAN Free Trade Agreement, which will expose Lao P.D.R. to increased competition:

- The authorities are drawing up a comprehensive strategic plan to set out reform options for state-owned enterprises. Staff encouraged prompt operationalization and implementation of the plans, using expertise from multilateral and bilateral partners as needed.

- The authorities have recently stepped up efforts to prepare for accession to WTO membership. Staff encouraged the authorities to build on the momentum and address outstanding issues raised by the WTO Working Party with regard to pricing policy, customs valuation methods, sanitary and phyto-sanitary rules, and laws and regulations with regard to intellectual property rights.

21. **Improving the quality and timeliness of economic statistics would strengthen policy making.** The absence of timely data across all sectors impedes analysis of recent trends. Increasing delays in monetary statistics associated with implementation of the new chart of accounts has been particularly worrisome. The absence of reliable balance of payment statistics and gaps in fiscal reporting are additional areas for improvement. Sufficient resources should be dedicated to data collection and compilation, while enhanced coordination among statistical agencies would improve data quality and consistency. Participation in the IMF's General Data Dissemination System (GDDS) could help in this regard. The draft Statistics Law would enhance the mandate of the National Department of Statistics and facilitate an increase in staffing. Staff is hopeful that its passage, which appears imminent, will contribute to a strengthening of macroeconomic statistics. Staff noted that the IMF stands ready to increase its technical assistance to Lao P.D.R.

IV. STAFF APPRAISAL

22. **Lao P.D.R.'s economy has held up remarkably well, despite the global recession.** The crisis had an impact on exports, nonregional tourism and capital inflows. However, supported by ongoing projects in the mining and hydropower sector as well as expansionary fiscal and monetary policies, growth has remained higher than the average for low-income countries in Asia. At the same time, the authorities managed to contain inflation below the average for low-income countries in Asia. As a result, important gains continue to be made in improving living standards and reducing poverty. The authorities deserve credit for that.

23. **However, expansionary macroeconomic policies put pressure on the balance of payments.** Expansionary fiscal and monetary policies alongside the rapid growth of the banking system have stimulated domestic demand and imports. In conjunction with the stabilized exchange rate regime, this has put NFA of the banking system on a downward trend since mid-2008. As a result, the liquidity buffer to absorb external and internal shocks is now substantially less comfortable than during 2000–07 and the authorities should take this into consideration when assessing the adequacy of central bank reserves.

24. **The outlook for GDP growth in 2010 is favorable and inflation is likely to remain moderate, but pressures on the external position are likely to continue.** The projected narrowing of the fiscal deficit in FY2010 would make an important initial contribution to the needed policy tightening. However, on current policies, the growth of credit is expected to remain strong, boosting domestic demand and imports, and raising risks in the financial sector.

25. **The overall fiscal deficit, which looks set to narrow by about 2 percent of GDP in FY2010, should be kept on a consolidation path over the medium term.** In this regard, staff welcomes the phasing out of the off-budget spending financed by direct lending from the central bank to provincial governments. The needed medium-term fiscal consolidation should build on recent revenue gains, including from the resources sector and the newly-introduced VAT, and a prioritization of infrastructure spending.

26. **The authorities should articulate a plan aimed at reducing the growth of credit to the private sector.** The extent of the further decline in banking system NFA during 2010 will depend to a large degree on the authorities' success in reining in private sector credit growth. In light of this, all available instruments should be considered, including raising reserve requirements, stepping up sales of central bank securities to the domestic banks, raising the policy rate, and using prudential curbs.

27. **Staff believes that the kip is overvalued, but that a stabilized exchange rate regime remains the appropriate monetary anchor for Lao P.D.R.** In view of the higher risk of financial crisis and slower and more abrupt external adjustment typically associated with pegs and near-pegs, and in light of the downward trend in NFA of the banking system, this makes it all the more important to implement consistent fiscal and monetary policies.

28. **The rapid expansion of the number of banks and the rapid growth of credit in many banks poses high credit risks and call for extra vigilance by bank supervisors.** Bank lending standards should be scrutinized and a tightening of these standards should be mandated, if deemed necessary. Existing prudential regulations should be clarified and enforced, including loan classification rules and regulations which limit banks' net open foreign currency position and prohibit bank lending in foreign currency to borrowers without foreign currency income.

29. **Lao P.D.R.'s medium-term prospects are promising, provided that a concerted effort is made to preserve macroeconomic stability.** Efforts to strengthen the soundness of the financial system should be complemented by efforts to improve the business climate and trade integration. State-owned enterprise (SOE) reforms and regulatory and legal reform required for accession to WTO membership can be expected to have important long-run payoffs.

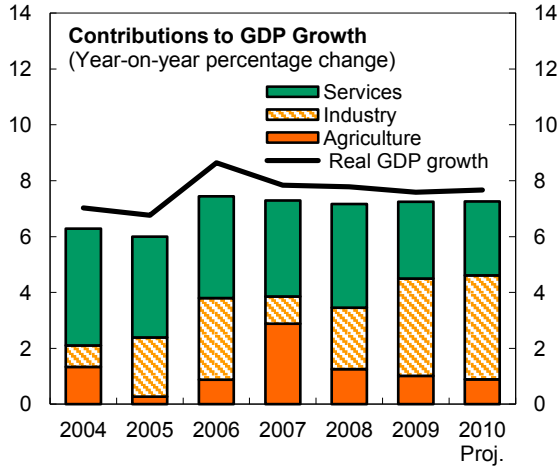
30. **Improvements in the quality and timeliness of statistics would improve analysis and policy making.** Improvements in balance of payments and national account statistics are particularly urgent.

31. Staff welcomes the authorities' recent acceptance of the obligations under Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement.

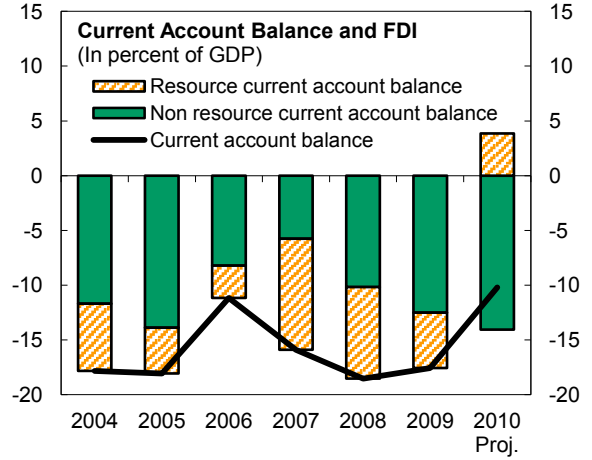
32. It is recommended that the next Article IV consultation with Lao P.D.R. take place on the standard 12-month cycle.

Figure 1. Lao P.D.R.: Real and External Sector Developments

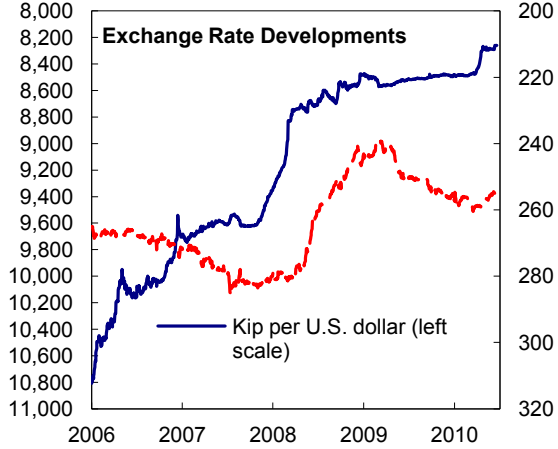
Growth has remained strong, supported by large investments in the resource (mining and hydro) sector.



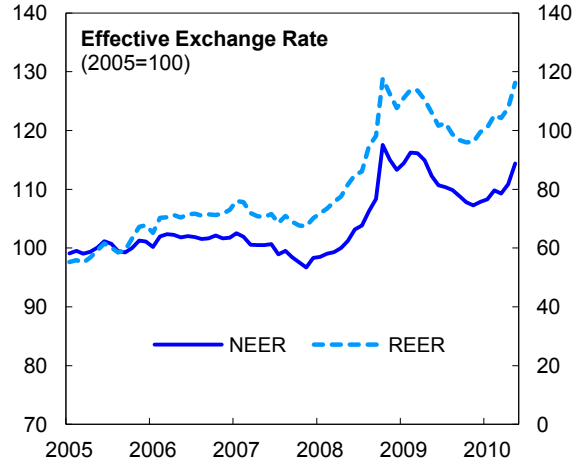
Movements in the current account in recent years have been driven mostly by the resource sector.



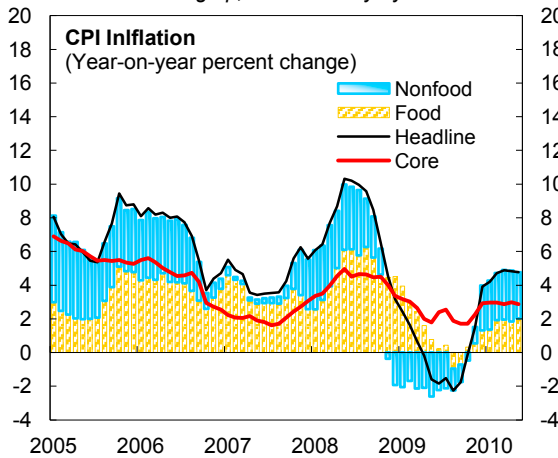
During April 2010, the kip appreciated by 2 percent against the U.S. dollar.



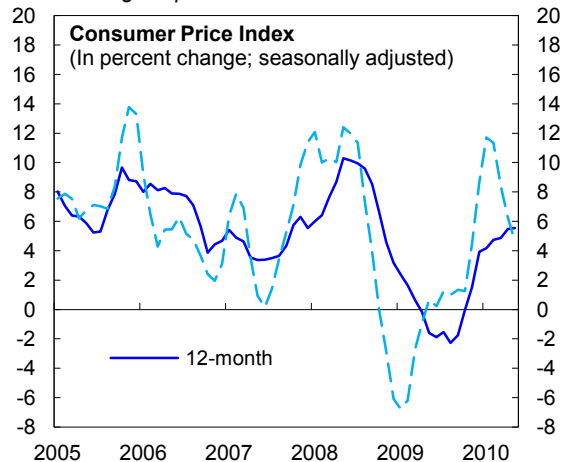
The REER is 17 percent more appreciated than the 2007 average.



Inflation is trending up, driven mostly by nonfood items.



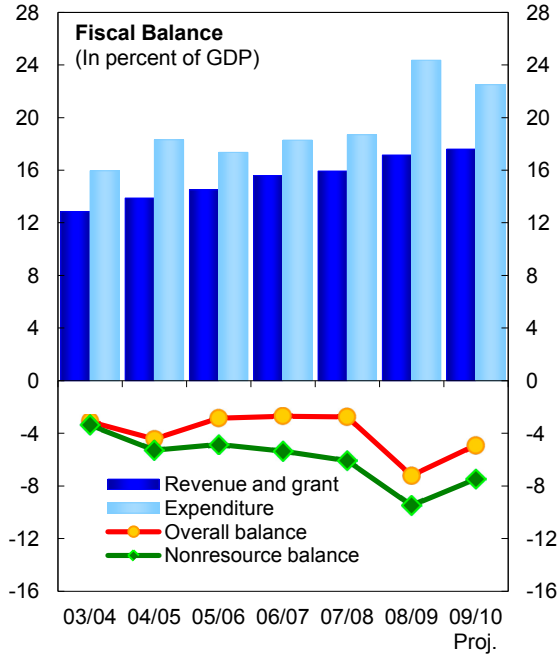
Seasonally adjusted, prices rose at a 4 percent annual rate during the past three months.



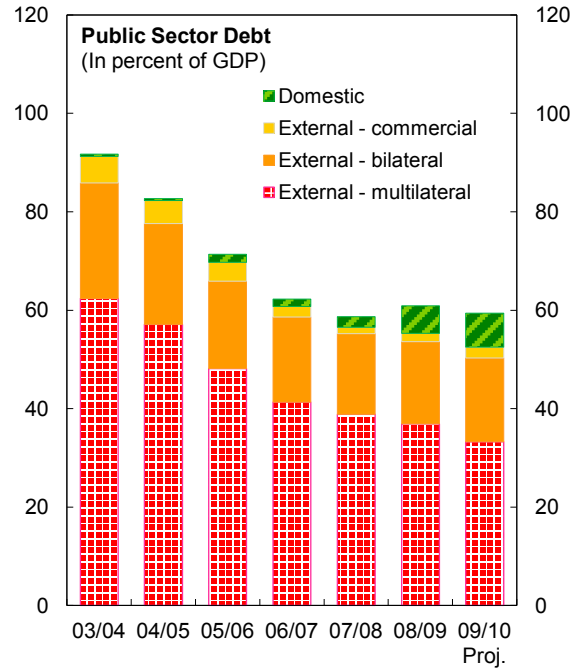
Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.

Figure 2. Lao P.D.R.: Fiscal Developments

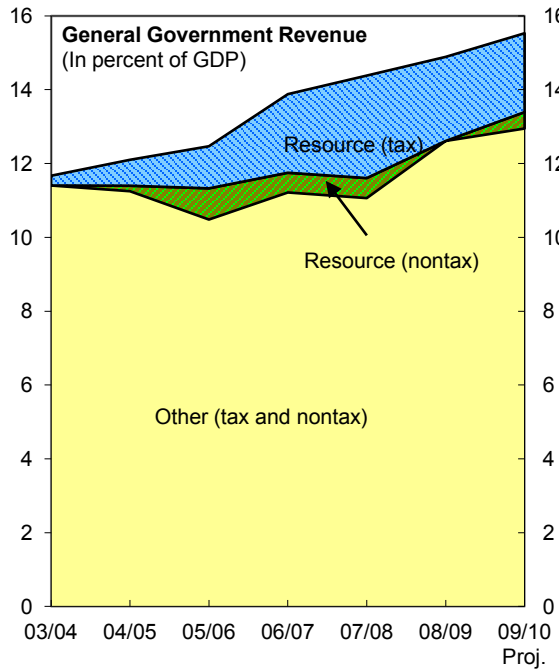
The fiscal deficit widened in FY08/09 due to higher spending.



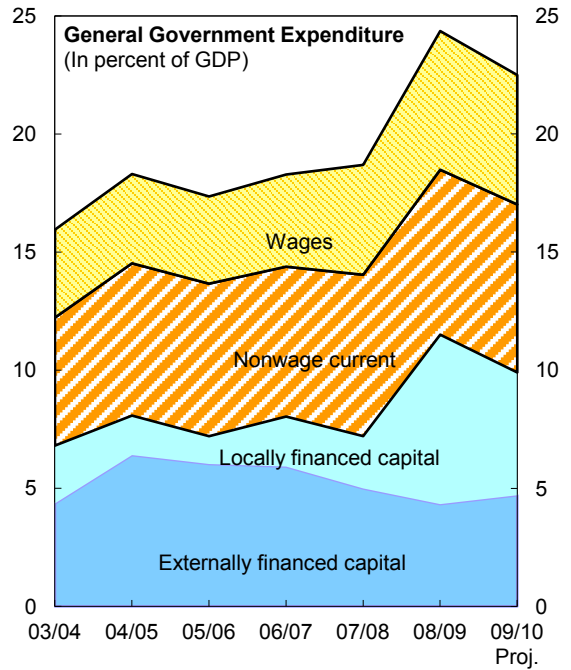
Public sector debt is on a declining trend.



Weaker copper prices have moderated the trend increase in resource-related revenues.



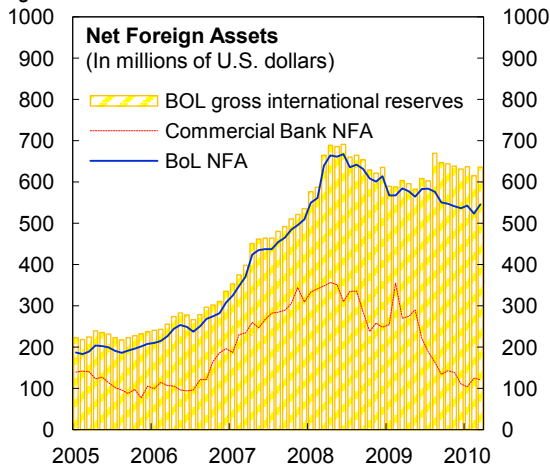
The wage bill and domestically-financed capital spending rose sharply in FY08/09.



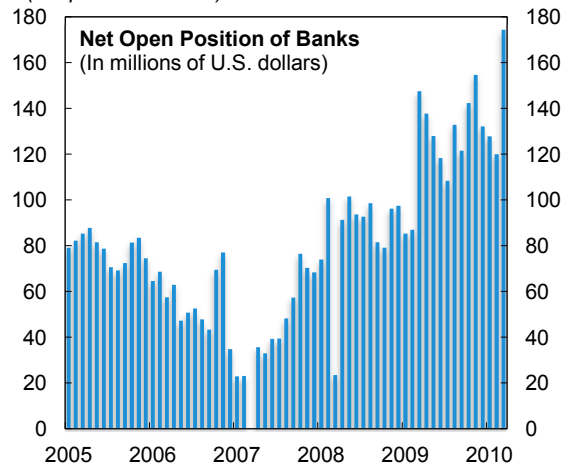
Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.

Figure 3. Lao P.D.R.: Monetary Developments

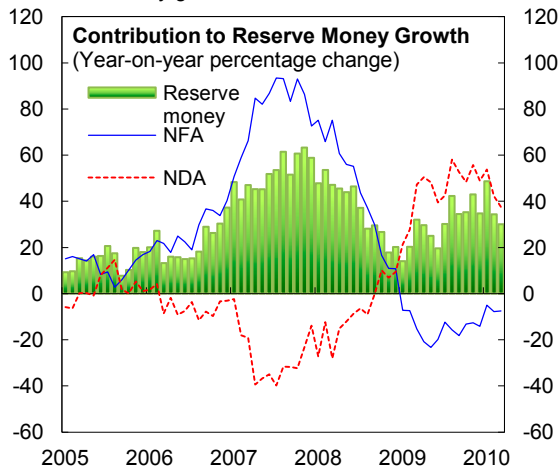
NFA of the BoL and the banks are both trending down. The August SDR allocation (US\$65 million) supported gross reserves.



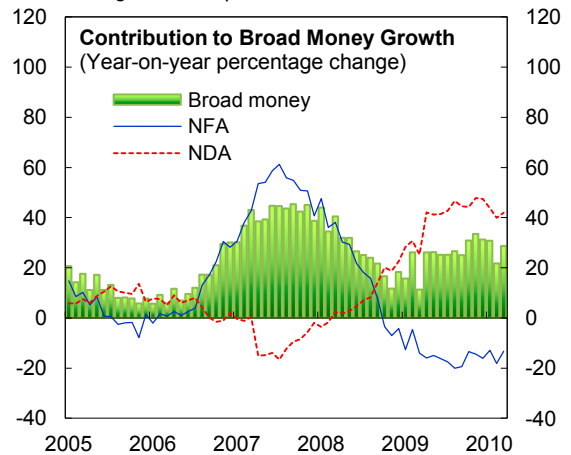
Banks' NOP has remained above US\$100 million (1.8 percent of GDP).



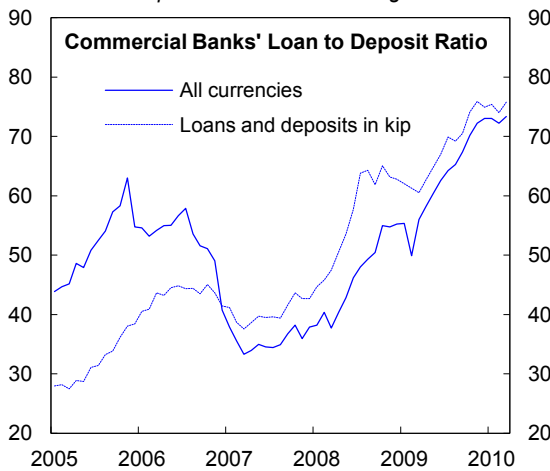
The decline in NFA has limited the acceleration of reserve money growth...



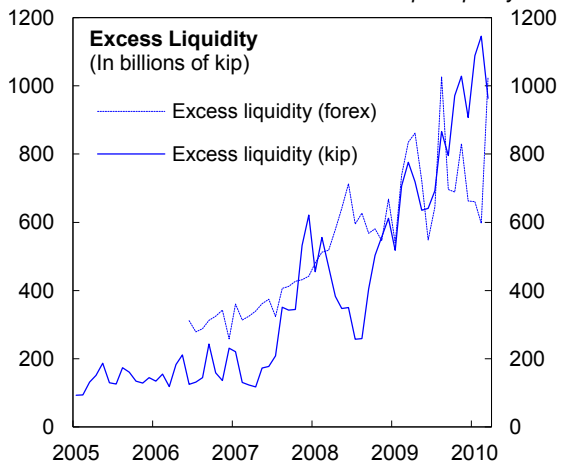
...and M2 growth, despite a credit boom.



The loan-to-deposit ratio has been rising...



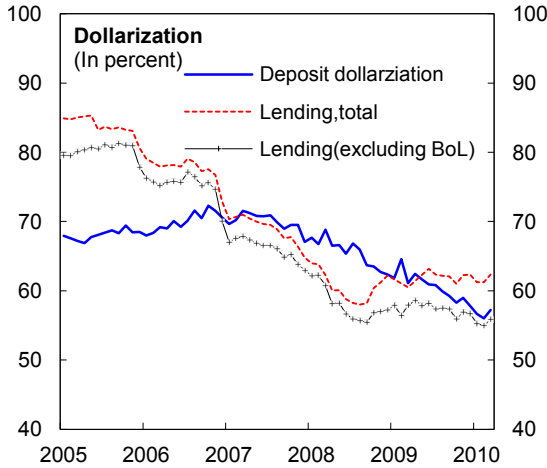
...but could rise further as banks have ample liquidity.



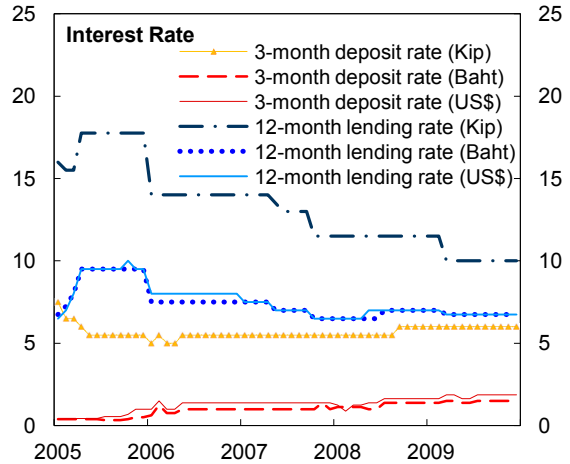
Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates.

Figure 4. Lao P.D.R.: Monetary and Credit Developments

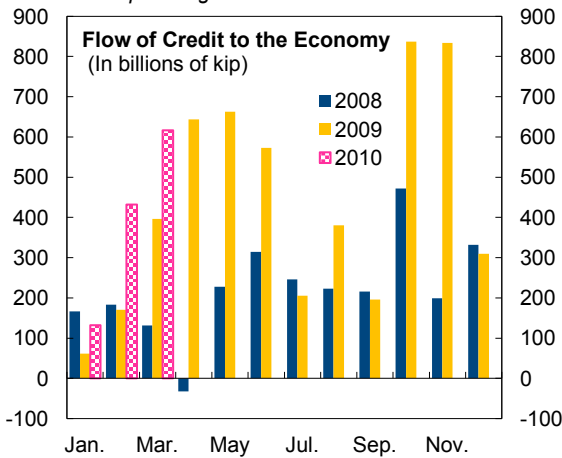
Deposit dollarization continues to inch down. Lending dollarization stabilized since the onset of the global financial crisis.



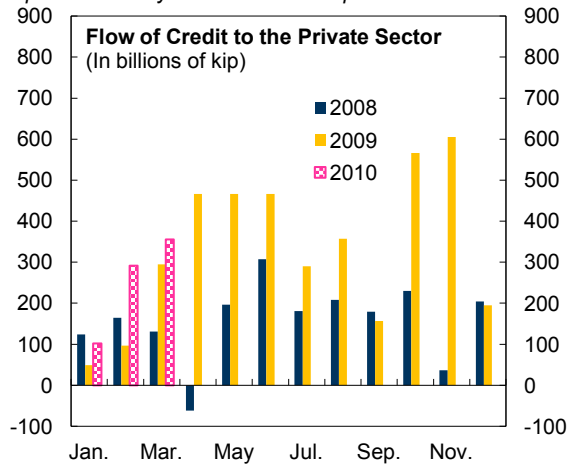
Rates on kip loans remain substantially higher than on forex loans.



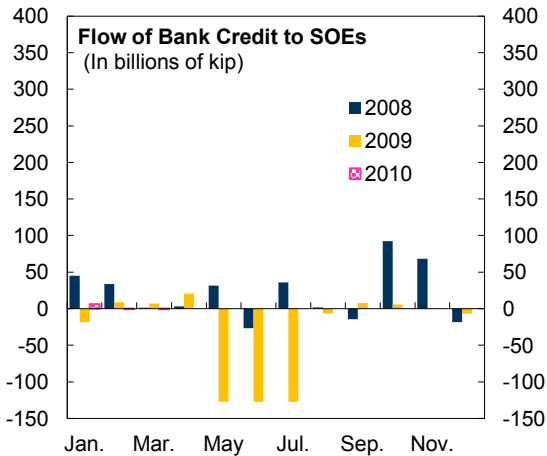
The flow of new credit peaked during the second quarter of 2009. It spiked again in October and November...



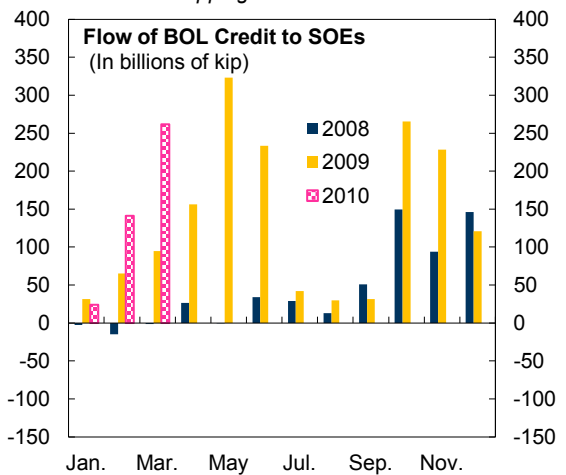
...spearheaded by bank credit to the private sector.



The flow of bank credit to SOEs has been limited...



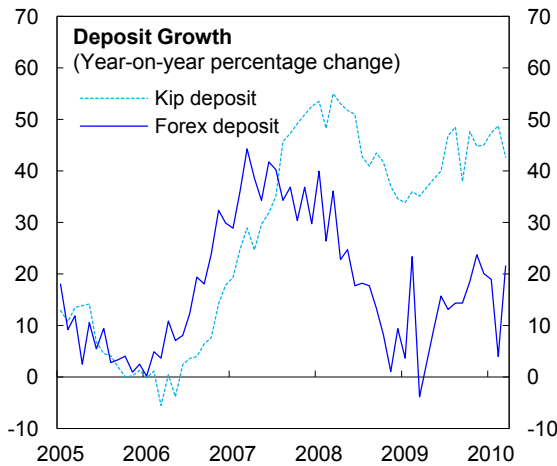
...with the BOL stepping in instead.



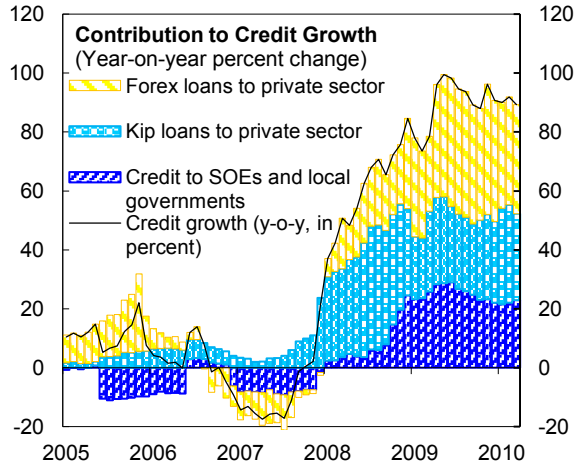
Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates.

Figure 5. Lao P.D.R.: Monetary and External Developments

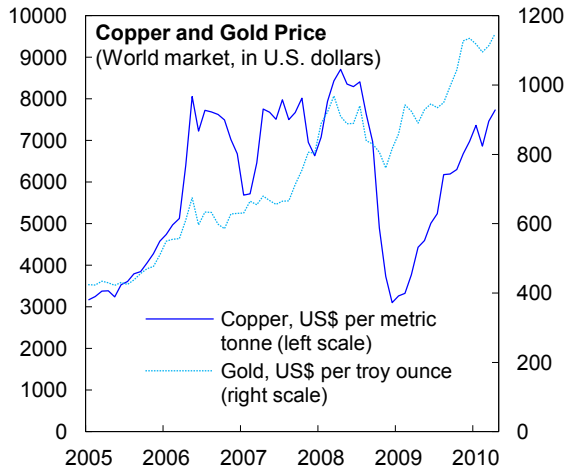
The stability of the exchange rate and the interest rate premium have caused kip deposits to grow faster than forex deposits.



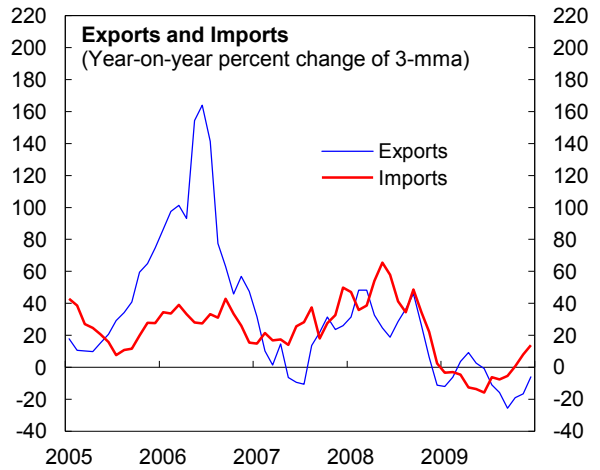
Credit to the economy increased by 89 percent in March (y-o-y).



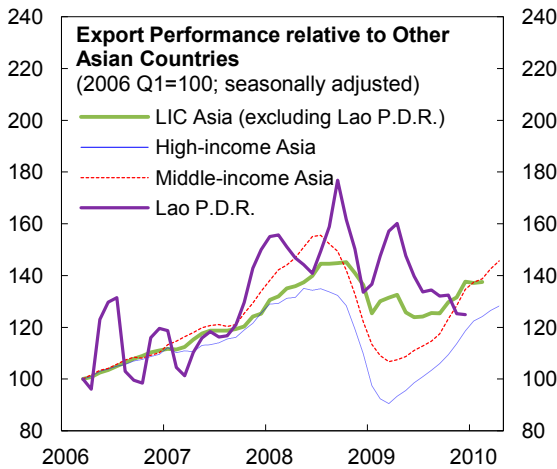
World market prices of copper and gold have been very volatile.



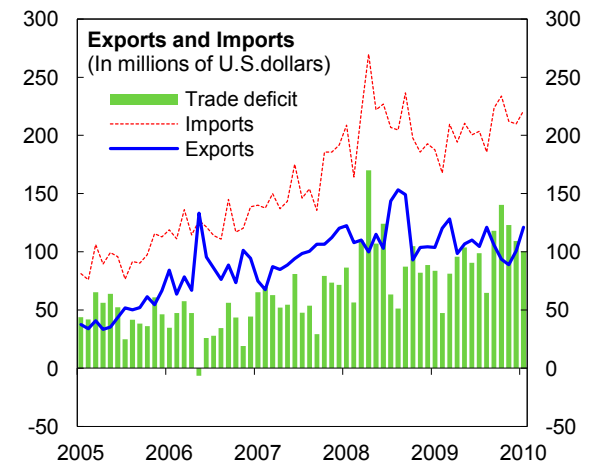
Import growth is now in positive territory (y/y). Exports are still down 6 percent (y/y).



Through August 2009, Lao P.D.R.'s exports held up relatively well.



The trade deficit has been widening.



Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates.

Table 1. Lao P.D.R.: Selected Economic and Financial Indicators, 2005–10

	2005	2006	2007	2008	2009 Est.	2010 Proj.
GDP and prices (percentage change)						
Real GDP growth	6.8	8.6	7.8	7.8	7.6	7.7
CPI (annual average)	7.2	6.8	4.5	7.6	0.0	5.4
CPI (end year)	8.8	4.7	5.6	3.2	3.9	5.5
Public finances (in percent of GDP) 1/						
Revenue	12.1	12.5	13.9	14.4	14.9	15.5
<i>Of which: Resources 2/</i>	0.9	2.0	2.7	3.3	2.3	2.6
Grants	1.8	2.0	1.7	1.6	2.3	2.1
Expenditure	18.3	17.4	18.3	18.7	24.4	22.5
Current (includes contingency and discrepancy)	10.2	10.1	10.2	11.5	12.9	12.6
Capital and net lending 3/	8.1	7.2	8.0	7.2	11.5	9.9
Overall balance (including grants) 3/	-4.4	-2.9	-2.7	-2.8	-7.2	-4.9
Domestic financing	-0.1	-1.2	-1.1	-0.3	5.0	3.1
External financing	4.5	4.1	3.8	3.0	2.2	1.8
Money and credit (annual percent change) 4/						
Reserve money	18.2	37.2	58.8	20.2	34.7	1.2
Broad money	7.7	30.1	38.7	18.3	31.3	25.0
Bank credit to the economy 4/	7.6	-9.1	21.0	84.6	90.7	42.9
Interest rates (end-of-period)						
On three-month kip deposits	5.5	5.5	5.5	6.0	6.0	...
On short-term kip loans (one year)	17.8	14.0	11.5	11.5	10.0	...
Balance of payments						
Exports (in millions of U.S. dollars)	697	1,133	1,321	1,605	1,485	2,125
In percent change	30.1	62.6	16.6	21.5	-7.5	43.1
Imports (in millions of U.S. dollars)	1,270	1,602	2,158	2,829	2,720	3,031
In percent change	20.3	26.1	34.7	31.1	-3.9	11.5
Current account balance (in millions of U.S. dollars)	-492	-398	-672	-985	-984	-647
In percent of GDP	-18.1	-11.2	-15.9	-18.5	-17.6	-10.2
Gross official reserves (in millions of U.S. dollars)	238	336	528	636	632	555
In months of prospective goods and services imports 5/	2.2	2.5	2.8	3.3	2.8	2.0
External public debt and debt service						
External public debt						
In millions of U.S. dollars	2,203	2,351	2,521	2,949	3,109	3,270
In percent of GDP	80.8	66.0	59.7	55.5	55.5	51.6
External public debt service						
In percent of exports	7.4	3.6	4.0	4.3	5.0	4.8
Exchange rate						
Official exchange rate (kip per U.S. dollar; end-of-period) 6/	10,767	9,655	9,341	8,466	8,476	8,291
Real effective exchange rate (2000=100) 7/	99.1	104.4	104.5	114.1	120.3	122.7
Memorandum items:						
GDP at current market prices						
In billions of kip	28,948	35,981	40,467	46,215	47,567	53,727
In millions of U.S. dollars	2,726	3,564	4,226	5,313	5,598	6,341

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.

1/ Fiscal year basis (October to September).

2/ Royalties and taxes from mining and hydropower (resource) projects.

3/ Includes off-budget investment expenditures.

4/ Excludes debt write-offs. Includes Bank of Lao P.D.R. lending to state-owned enterprises and local governments.

5/ Excludes imports associated with large resource projects.

6/ Figure for 2010 is as of June 11, 2010.

7/ Figure for 2010 is as of May 2010.

Table 2. Lao P.D.R.: Balance of Payments, 2007–15

	2007	2008	2009	2010	2011	2012	2013	2014	2015
			Est.			Projections			
(In millions of U.S. dollars, unless otherwise indicated)									
Current account	-672	-985	-984	-647	-944	-1,148	-1,592	-2,253	-1,921
Merchandise trade balance	-837	-1,225	-1,235	-906	-1,200	-1,421	-1,903	-2,609	-2,352
Exports, f.o.b.	1,321	1,605	1,485	2,125	2,467	2,764	2,847	3,039	3,170
Mining and hydropower	663	865	912	1,459	1,653	1,834	1,864	1,946	1,962
Other exports	658	740	573	667	813	930	984	1,093	1,208
Imports, c.i.f.	2,158	2,829	2,720	3,031	3,667	4,186	4,751	5,648	5,522
Mining and hydropower	886	993	876	795	1,082	1,371	1,693	2,207	1,772
Petroleum imports	311	422	293	417	490	564	650	753	823
Other imports	961	1,414	1,551	1,819	2,095	2,250	2,409	2,688	2,927
Services (net)	202	331	330	352	370	392	418	447	479
Of which: Tourism	189	276	268	283	297	315	336	358	382
Income (net)	-141	-232	-207	-263	-305	-326	-331	-335	-318
Interest payments	-83	-79	-79	-135	-148	-146	-143	-158	-151
Of which: Public	-19	-26	-27	-44	-59	-65	-69	-79	-83
Mining and hydropower	-36	-35	-40	-84	-83	-75	-67	-70	-59
Dividends and profit repatriation	-216	-308	-322	-402	-507	-537	-544	-517	-450
Of which: Mining and hydropower	-169	-281	-279	-335	-427	-424	-384	-311	-197
Other	159	154	195	274	349	358	356	340	283
Transfers (net)	104	141	128	170	191	207	224	244	270
Private	51	64	35	44	53	58	64	71	78
Official	53	77	93	126	138	149	159	174	192
Capital account	873	1,089	906	575	945	1,299	1,720	2,426	2,100
Public sector	140	124	155	161	207	184	202	228	275
Disbursements	186	185	222	238	300	286	309	344	406
Amortization	-45	-61	-67	-78	-93	-102	-108	-115	-131
Banking sector (net)	-117	65	140	60	10	-10	-10	-10	-10
Private sector	850	900	611	354	728	1,125	1,529	2,108	1,835
Foreign direct investment (net) 1/	790	930	769	394	768	1,105	1,489	2,258	1,785
Of which: Mining and hydropower projects	670	781	712	198	564	667	902	1,531	1,092
Other private flows and errors and omissions	60	-29	-158	-40	-40	20	40	50	50
Overall balance	202	105	-77	-72	1	151	128	174	179
Financing	-202	-105	77	72	-1	-151	-128	-174	-179
Central bank net foreign assets	-202	-105	77	72	-1	-151	-128	-174	-179
Assets (increase -)	-200	-100	4	77	4	-147	-125	-170	-175
Liabilities (reduction -)	-2	-4	74	-5	-5	-4	-4	-4	-4
Memorandum items:									
Current account balance (in percent of GDP)	-15.9	-18.5	-17.6	-10.2	-13.6	-15.4	-19.9	-25.8	-19.9
Excluding official transfers	-17.1	-20.0	-19.2	-12.2	-15.6	-17.4	-21.9	-27.8	-21.9
Resource current account balance (in percent of GDP) 2/	-10.1	-8.4	-5.0	3.9	0.9	-0.5	-3.5	-7.4	-0.7
Nonresource current account balance (in percent of GDP)	-5.8	-10.2	-12.5	-14.1	-14.5	-14.9	-16.4	-18.5	-19.2
Exports (annual percent change)	16.6	21.5	-7.5	43.1	16.1	12.1	3.0	6.7	4.3
Imports (annual percent change)	34.7	31.1	-3.9	11.5	21.0	14.1	13.5	18.9	-2.2
Excluding hydro and mining related			0.4	21.3	15.6	8.9	8.7	12.5	9.0
Gold production (000s oz.)	134	140	162	148	160	160	110	110	110
Gold price (U.S. dollar per oz.)	697	872	973	1,183	1,221	1,245	1,281	1,329	1,380
Copper production (000s ton)	63	89	122	135	140	145	135	135	135
Copper price (U.S. dollar per ton)	7,132	6,963	5,165	7,200	7,500	7,000	6,500	6,000	5,000
Gross official reserves (in millions of U.S. dollars)	528	636	632	555	551	699	823	993	1,168
In months of prospective imports of goods and nonfactor services	2.2	2.7	2.4	1.8	1.5	1.7	1.7	2.1	2.6
(Excluding imports associated with large resource projects)	2.8	3.3	2.8	2.0	1.8	1.9	1.9	2.3	2.7
Nominal GDP at market prices (in millions of U.S. dollars)	4,226	5,313	5,598	6,341	6,954	7,463	8,011	8,722	9,667

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.

1/ Includes repayment of private debt. FDI in the balance of payments includes both equity and debt, whereas only the nondebt portion is included in the debt sustainability analysis.

2/ Pertains to large mining and hydropower (resource) projects.

Table 3. Lao P.D.R.: General Government Operations, 2005/06–2010/11

	2005/06	2006/07	2007/08	2008/09			2009/10		2010/11
				Budget	Art. IV Proj.	Est.	Budget	Staff Proj.	Staff Proj.
(In billions of kip)									
Revenue and grants	4,962	6,134	7,134	8,065	7,275	8,099	8,907	9,184	11,126
Revenue	4,266	5,460	6,439	7,313	6,276	7,030	7,825	8,103	9,963
<i>Of which</i> : Resource revenue 1/	680	1,048	1,486	1,701	1,338	1,075	2,185	1,347	2,185
Tax revenue	3,641	4,711	5,627	6,338	5,557	6,208	6,989	7,224	8,953
<i>Of which</i> : Resource revenue 1/	390	838	1,243	1,468	1,134	1,075	1,959	1,115	1,959
Income and profit taxes	693	1,170	1,655	1,804	1,479	1,728	1,487	1,699	2,556
Income taxes	234	252	333	364	358	425	494	449	522
Profit taxes	459	919	1,322	1,440	1,121	1,303	993	1,251	2,034
Turnover tax	887	1,046	1,229	1,347	1,178	1,401	1,697	1,736	2,040
Excise duties	800	999	1,190	1,432	1,412	1,432	1,799	1,716	2,001
Import duties	515	573	674	834	635	726	746	846	943
Royalties	275	322	373	373	336	297	377	527	681
Mining	218	274	317	312	261	219	258	410	496
Hydropower	57	48	56	61	75	78	118	117	186
Other taxes	471	601	507	549	517	623	884	700	730
Nontax revenue	625	749	812	975	719	823	836	879	1,010
<i>Of which</i> : Dividends	...	157	293	482	274	338	372	309	386
<i>Of which</i> : Resource revenue 1/	289	211	243	234	204	0	233	233	226
Grants	696	674	695	752	999	1,068	1,081	1,081	1,163
Expenditure	5,938	7,192	8,368	9,881	11,058	11,501	10,105	11,738	12,505
Current expenditure	3,124	3,445	4,576	5,702	5,745	5,570	5,915	5,920	6,946
Wages, salaries, and benefits	1,263	1,534	2,082	2,793	2,793	2,772	2,830	2,859	3,215
Transfers	674	806	1,095	1,327	1,454	1,369	1,391	1,303	1,499
Interest payments	277	277	361	388	388	264	502	316	555
<i>Of which</i> : External	244	244	291	329	329	205	422	238	329
Other recurrent	911	828	1,037	1,195	1,110	1,166	1,192	1,442	1,676
Capital expenditure and onlending	2,465	3,161	3,227	3,667	4,800	5,431	3,540	5,167	4,974
Domestically financed	403	833	991	1,485	2,608	3,387	1,265	2,713	2,292
<i>Of which</i> : Off-budget	...	...	255	...	1,151	1,933	...	1,613	...
Externally financed and onlending 2/	2,062	2,328	2,235	2,181	2,192	2,044	2,275	2,455	2,682
Externally financed	2,192	2,248	2,185	2,192	2,208	2,085	2,404	2,404	2,165
Onlending (net)	-130	81	50	-11	-16	-42	-129	50	517
Others and contingencies 3/	348	586	566	512	512	500	650	650	585
Overall balance	-976	-1,058	-1,234	-1,816	-3,783	-3,403	-1,198	-2,553	-1,379
Overall balance (excluding off-budget)	...	...	-979	...	-2,632	-1,470	...	-941	...
Nonresource balance 4/	-1,655	-2,107	-2,721	-3,517	-5,121	-4,478	...	-3,900	-3,564
Primary balance	-699	-782	-873	-1,428	-3,395	-3,139	-697	-2,237	-824
Financing	976	1,058	1,234	1,816	3,783	3,403	1,198	2,553	1,379
Domestic financing (net)	-415	-426	-129	664	2,631	2,359	243	1,597	0
Bank financing	-179	-265	-650	567	1,928	1,788	81	1,240	0
<i>Of which</i> : Off-budget (local government)	...	...	...	...	615	1,397	...	1,416	0
<i>Of which</i> : State Accumulation Fund	...	...	-234	-50	-50	-50	-110	-110	-50
Nonbank financing	16	0	519	17	704	638	161	358	0
<i>Of which</i> : Off-budget (SEA game related)	...	...	118	...	536	536	...	196	...
Other financing (including discrepancy)	-252	-161	1	0	0	-67	0	0	...
Foreign financing (net)	1,390	1,484	1,363	1,151	1,151	1,044	956	956	1,379
Disbursements	1,703	1,836	1,765	1,605	1,605	1,554	1,523	1,523	2,005
Amortization	-312	-352	-402	-454	-454	-510	-567	-567	-626
Memorandum items:									
Nonresource current balance	462	967	377	-91	-807	385	...	836	832
GDP (in billions of kip)	34,223	39,346	44,778	50,591	48,391	47,225	54,100	52,187	58,522

Table 3. Lao P.D.R.: General Government Operations, 2005/06–2010/11 (concluded)

	2005/06	2006/07	2007/08	2008/09			2009/10		2010/11
				Budget	Art. IV Proj.	Est.	Budget	Staff Proj	Staff Proj
(In percent of GDP)									
Revenue and grants	14.5	15.6	15.9	15.9	15.0	17.1	16.5	17.6	19.0
Revenue	12.5	13.9	14.4	14.5	13.0	14.9	14.5	15.5	17.0
<i>Of which:</i> Resource revenue 1/	2.0	2.7	3.3	3.4	2.8	2.3	4.0	2.6	3.7
Tax revenue	10.6	12.0	12.6	12.5	11.5	13.1	12.9	13.8	15.3
<i>Of which:</i> Resource revenue 1/	1.1	2.1	2.8	2.9	2.3	...	3.6	2.1	3.3
Income and profit taxes	2.0	3.0	3.7	3.6	3.1	3.7	2.7	3.3	4.4
<i>Income taxes</i>	0.7	0.6	0.7	0.7	0.7	0.9	0.9	0.9	0.9
<i>Profit taxes</i>	1.3	2.3	3.0	2.8	2.3	2.8	1.8	2.4	3.5
Turnover tax	2.6	2.7	2.7	2.7	2.4	3.0	3.1	3.3	3.5
Excise duties	2.3	2.5	2.7	2.8	2.9	3.0	3.3	3.3	3.4
Import duties	1.5	1.5	1.5	1.6	1.3	1.5	1.4	1.6	1.6
Royalties	0.8	0.8	0.8	0.7	0.7	0.6	0.7	1.0	1.2
Other taxes	1.4	1.5	1.1	1.1	1.1	1.3	1.6	1.3	1.2
Nontax revenue	1.8	1.9	1.8	1.9	1.5	1.7	1.5	1.7	1.7
<i>Of which:</i> Resource revenue 1/	0.8	0.5	0.5	0.5	0.4	...	0.4	0.4	0.4
Grants	2.0	1.7	1.6	1.5	2.1	2.3	2.0	2.1	2.0
Expenditure	17.4	18.3	18.7	19.5	22.9	24.4	18.7	22.5	21.4
Current expenditure	9.1	8.8	10.2	11.3	11.9	11.8	10.9	11.3	11.9
Wages, salaries, and benefits	3.7	3.9	4.7	5.5	5.8	5.9	5.2	5.5	5.5
Transfers	2.0	2.0	2.4	2.6	3.0	2.9	2.6	2.5	2.6
Interest payments	0.8	0.7	0.8	0.8	0.8	0.6	0.9	0.6	0.9
<i>Of which:</i> External	0.7	0.6	0.7	0.7	0.7	0.4	0.8	0.5	0.6
Other recurrent	2.7	2.1	2.3	2.4	2.3	2.5	2.2	2.8	2.9
Capital expenditure and onlending	7.2	8.0	7.2	7.2	9.9	11.5	6.5	9.9	8.5
Domestically financed	1.2	2.1	2.2	2.9	5.4	7.2	2.3	5.2	3.9
<i>Of which:</i> Off-budget	...	...	0.6	...	2.4	4.1	...	3.1	...
Externally financed and on-lending 2/	6.0	5.9	5.0	4.3	4.5	4.3	4.2	4.7	4.6
Externally financed	6.4	5.7	4.9	4.3	4.6	4.4	4.4	4.6	3.7
Onlending (net)	-0.4	0.2	0.1	0.0	0.0	-0.1	-0.2	0.1	0.9
Others and contingencies 3/	1.0	1.5	1.3	1.0	1.1	1.1	1.2	1.2	1.0
Overall balance	-2.9	-2.7	-2.8	-3.6	-7.8	-7.2	-2.2	-4.9	-2.4
Overall balance (excluding off-budget)	...	...	-2.2	...	-5.4	-3.1	...	-1.8	...
Nonresource balance 4/	-4.8	-5.4	-6.1	-7.0	-10.6	...	...	-7.5	-6.1
Primary balance	-2.0	-2.0	-1.9	-2.8	-7.0	-6.6	-1.3	-4.3	-1.4
Financing	2.9	2.7	2.8	3.6	7.8	7.2	2.2	4.9	2.4
Domestic financing (net)	-1.2	-1.1	-0.3	1.3	5.4	5.0	0.4	3.1	0.0
Bank financing	-0.5	-0.7	-1.5	1.1	4.0	3.8	0.2	2.4	0.0
<i>Of which:</i> Off-budget (local government)	...	...	...	...	1.3	3.0	0.0	2.7	...
State Accumulation Fund	...	...	-0.5	-0.1	-0.1	...	-0.2	-0.2	-0.1
Nonbank financing	0.0	0.0	1.2	0.0	1.5	1.4	0.3	0.7	0.0
<i>Of which:</i> Off-budget (SEA game related)	...	...	0.3	...	1.1	...	...	0.4	...
Other financing (including discrepancy)	-0.7	-0.4	0.0	0.0	0.0	-0.1	0.0	0.0	...
Foreign financing (net)	4.1	3.8	3.0	2.3	2.4	2.2	1.8	1.8	2.4
Disbursements	5.0	4.7	3.9	3.2	3.3	3.3	2.8	2.9	3.4
Amortization	-0.9	-0.9	-0.9	-0.9	-0.9	-1.1	-1.0	-1.1	-1.1
Memorandum items:									
Nonresource current balance	1.3	2.5	0.8	-0.2	-1.7	0.8	...	1.6	1.4
GDP (in billions of kip)	34,223	39,346	44,778	50,591	48,391	47,225	54,100	52,187	58,522

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.

1/ Resource revenue comprises royalties, taxes, and dividends from the mining and hydropower sectors.

2/ Onlending includes gross repayments of funds.

3/ Includes payments on liabilities carried over from the previous budget years and for arrears clearance.

4/ Overall balance net of resource revenue.

Table 4. Lao P.D.R.: Monetary Survey 2007–10

	2007		2008		2009			2010		
	Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Proj.
(In billions of kip)										
Bank of Lao P.D.R. (BoL)										
Net foreign assets	4,803	5,457	5,230	5,012	4,967	4,690	4,555	4,613	4,088	3,933
In millions of U.S. dollars	510	632	614	585	583	551	537	546	482	464
Net domestic assets	-829	-1,229	-454	311	179	995	1,880	2,310	2,699	2,581
Government (net)	-456	-1,396	-1,057	-636	-1,502	-761	-815	-881	-658	-701
Claims	907	533	973	1,160	978	936	925	950	900	975
Deposits	-1,363	-1,929	-2,030	-1,796	-2,480	-1,698	-1,740	-1,831	-1,558	-1,676
Of which: Foreign currency	-1,042	-1,520	-1,501	-1,367	-2,113	-1,269	-1,143	-1,209	-1,023	-1,101
State-owned enterprises	161	296	685	876	1,589	1,692	2,312	2,739	2,939	2,883
Of which: kip	0	0	0	202	250	290	373	405	475	465
Local governments	0	0	389	581	1,293	1,397	2,017	2,443	2,643	2,587
Banks	192	500	538	628	865	1,029	1,173	1,262	1,478	1,550
BoL securities	0	-151	-223	-301	-557	-670	-660	-844	-1,144	-1,250
Other items (net)	-726	-477	-397	-256	-216	-295	-130	35	84	100
Reserve money	3,974	4,228	4,776	5,324	5,146	5,685	6,436	6,923	6,787	6,514
Currency in circulation	1,838	1,776	2,223	2,377	2,271	2,409	3,086	2,944	3,060	3,800
Bank reserves (kip)	1,040	1,133	1,163	1,307	1,542	1,608	1,705	2,074	2,164	1,585
Of which: Capital deposits	77	305	170	133	251	148	168	306	306	306
Bank reserves (foreign currency)	1,095	1,319	1,390	1,638	1,333	1,658	1,644	1,905	1,563	1,129
Monetary survey										
Net foreign assets	7,779	7,932	7,368	7,301	6,859	5,835	5,500	5,649	4,650	4,367
In millions of U.S. dollars	826	918	865	852	805	685	648	669	549	516
Of which: Commercial banks	316	287	251	267	222	134	111	123	66	51
Net domestic assets	1,995	2,857	4,196	5,143	6,042	7,653	9,678	10,358	12,315	14,608
Government (net)	-275	-990	-643	-274	-1,192	-472	-627	-1,082	-479	-479
Budget	-667	-1,451	-1,104	-885	-1,803	-1,060	-1,215	-1,670	-1,066	-1,066
Claims	1,312	758	1,194	1,175	1,118	1,017	1,080	1,173	1,362	1,224
Deposits	-1,979	-2,209	-2,298	-2,060	-2,920	-2,076	-2,294	-2,843	-2,428	-2,290
Other	392	461	461	611	611	588	588	588	588	588
Credit to the economy	3,166	4,842	5,845	6,512	8,242	9,157	11,143	12,323	13,631	15,924
In kip	1,115	2,024	2,208	2,573	3,034	3,473	4,195	4,639	5,131	5,994
In foreign currencies	2,052	2,818	3,637	3,939	5,208	5,684	6,948	7,684	8,500	9,930
Of which: private credit	2,654	4,082	4,554	4,994	6,394	7,198	8,565	9,314	10,390	12,673
Other items (net)	-896	-994	-1,005	-1,095	-1,008	-1,032	-838	-883	-838	-838
Broad money	9,774	10,789	11,564	12,444	12,900	13,488	15,178	16,008	16,965	18,975
Currency outside banks	1,838	1,776	2,223	2,377	2,271	2,409	3,086	2,944	3,060	3,800
Kip deposits	2,612	3,273	3,517	3,917	4,154	4,514	5,100	5,587	6,377	6,950
Foreign currency deposits (FCDs)	5,324	5,740	5,824	6,150	6,475	6,565	6,992	7,476	7,528	8,225
(Annual percent change, unless otherwise indicated)										
Reserve money	58.8	29.6	20.2	32.0	19.6	34.5	34.7	30.0	19.4	1.2
Broad money	38.7	21.7	18.3	11.3	25.2	25.0	31.3	28.6	25.8	25.0
Credit to the economy	21.0	65.5	84.6	78.5	98.2	89.1	90.7	89.2	48.9	42.9
Credit to the private sector	28.8	70.3	71.6	62.5	81.9	76.3	88.1	86.5	44.4	48.0
Memorandum items:										
Money multiplier (at current exchange rates)	2.5	2.6	2.4	2.3	2.5	2.4	2.4	2.3	2.5	2.9
Velocity	4.1	4.3	4.0	3.8	3.7	3.5	3.1	3.4	3.2	2.8
Loan/deposit (percent)	37.9	50.4	55.2	56.0	62.6	67.4	73.0	73.4	76.9	85.9
In kip (percent)	42.7	61.8	62.8	60.5	67.0	70.5	74.9	75.8	73.0	79.6
Gross official reserves (in millions of U.S. dollars)	536	654	636	604	602	648	633	636	574	555
Net international reserves (in millions of U.S. dollars) 1/	393	479	451	394	426	356	343	546	...	...
Issue of debt clearance/bank recapitalization bonds 2/	392	461	461	611	611	588	588	...	...	...
Exchange rate, end-of-period (kip per U.S. dollar)	9,423	8,636	8,514	8,567	8,523	8,513	8,483	8,445	...	...
Nominal GDP (in billions of kip)	40,467	46,215	46,215	47,567	47,567	47,567	47,567	53,727	53,727	53,727
Dollarization rate (FCDs/broad money; in percent)	54.5	53.2	50.4	49.4	50.2	48.7	46.1	46.7	44.4	43.3

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates.

1/ Defined as gross official reserves minus BoL foreign liabilities and the foreign exchange component of reserve money.

2/ Cumulative since end-June 2003.

Table 5. Lao P.D.R.: Medium-Term Macroeconomic Framework, 2007–15

	2007	2008	2009	2010	2011	2012	2013	2014	2015
			Est.	Projections					
(Percent change, unless otherwise indicated)									
Output and prices									
Real GDP	7.8	7.8	7.6	7.7	7.5	7.3	6.4	7.6	9.3
Excluding resource projects	5.0	6.5	5.3	6.2	6.3	6.4	7.3	7.2	7.5
Consumer prices (end-period)	5.6	3.2	3.9	5.5	5.7	5.2	4.1	3.5	3.5
(Annual average)	4.5	7.6	0.0	5.4	5.7	5.2	5.2	3.6	3.3
GDP per capita (in U.S. dollars)	688	849	878	976	1,050	1,106	1,165	1,248	1,360
Public finances (in percent of GDP) 1/									
Revenue	13.9	14.4	14.9	15.5	17.0	18.2	18.4	18.2	17.7
Of which: Resources	2.7	3.3	2.3	2.6	3.7	4.7	4.4	3.9	3.3
Grants	1.7	1.6	2.3	2.1	2.0	2.0	2.0	2.0	2.0
Expenditure	18.3	18.7	24.4	22.5	21.4	21.5	21.9	22.0	21.5
Current (including contingency and discrepancy)	10.2	11.5	12.9	12.6	12.9	12.8	12.7	12.7	12.6
Capital and onlending	8.0	7.2	11.5	9.9	8.5	8.7	9.2	9.3	8.9
Of which: Off-budget capital expenditure	...	0.6	4.1	2.7	...	...	...	...	...
Overall balance	-2.7	-2.8	-7.2	-4.9	-2.4	-1.3	-1.5	-1.8	-1.9
Balance of payments									
(In millions of U.S. dollars; unless otherwise indicated)									
Current account balance	-672	-985	-984	-647	-944	-1,148	-1,592	-2,253	-1,921
In percent of GDP	-15.9	-18.5	-17.6	-10.2	-13.6	-15.4	-19.9	-25.8	-19.9
Exports	1,321	1,605	1,485	2,125	2,467	2,764	2,847	3,039	3,170
Of which: Resources	663	865	912	1,459	1,653	1,834	1,864	1,946	1,962
Imports	2,158	2,829	2,720	3,031	3,667	4,186	4,751	5,648	5,522
Of which: Resources	886	993	876	795	1,082	1,371	1,693	2,207	1,772
Services and income (net)	62	99	123	89	65	66	87	112	161
Transfers	104	141	128	170	191	207	224	244	270
Capital account balance	873	1,089	906	575	945	1,299	1,720	2,426	2,100
Of which: FDI	790	930	769	394	768	1,105	1,489	2,158	1,785
Overall balance	202	105	-77	-72	1	151	128	174	179
Trade (percent change)									
Exports	16.6	21.5	-7.5	43.1	16.1	12.1	3.0	6.7	4.3
Imports	34.7	31.1	-3.9	11.5	21.0	14.1	13.5	18.9	-2.2
External public debt and debt service									
External public debt (in percent of GDP)	59.7	55.5	55.5	51.6	50.0	49.0	48.2	46.9	45.2
External public debt service (in percent of exports)	4.0	4.3	5.0	4.8	5.2	5.1	5.2	5.4	5.7
Gross official reserves									
In millions of U.S. dollars	528	636	632	555	551	699	823	993	1,168
In months of imports of goods and nonfactor services	2.2	2.7	2.4	1.8	1.5	1.7	1.7	2.1	2.6
In months of imports (excluding resource projects)	2.8	3.3	2.8	2.0	1.8	1.9	1.9	2.3	2.7
Memorandum items:									
Nominal GDP (in billions of kip)	40,467	46,215	47,567	53,727	60,121	66,954	73,872	81,941	92,204
Nominal GDP (in millions of U.S. dollars)	4,226	5,313	5,598	6,341	6,954	7,463	8,011	8,722	9,667

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.

1/ Fiscal year basis (October to September).

Table 6. Lao P.D.R.: Financial Soundness Indicators, 2007–10

	2007	2008	2009	2010 1/
Capital adequacy ratio (Basel I)	...	25.0	20.1	21.6
State-owned commercial banks (SOCBs)	...	1.7	3.8	4.8
Joint-venture banks	...	30.6	9.0	9.9
Foreign bank branches	...	26.2	34.0	37.7
Private banks	...	41.5	33.5	34.1
NPL ratio	5.9	5.4	3.8	3.8
State-owned commercial banks	4.2	1.7	1.3	1.5
Joint-venture banks	12.7	4.5	1.3	1.6
Foreign bank branches	0.6	13.9	10.5	10.8
Private banks	...	1.4	1.9	1.2
Return on assets (select SOCBs only) 2/	0.9	3.1	...	...
Banque pour le Commerce Exterieur Lao	4.7	3.6	...	...
Lao Development Bank	0.8	2.2	...	...
Agricultural Promotion Bank	-2.8	3.6	...	...
Number of banks	13	20	23	23
State-owned commercial banks	4	4	4	4
Joint-venture banks	2	2	2	2
Foreign bank branches	6	9	10	10
Private banks	1	5	7	7
Sectoral allocation of bank credit (in percent of total)				
Industry and handicraft	22	19	...	...
Construction	4	4	...	...
Materials and technical supplies	8	9	...	...
Agriculture	8	13	...	...
Commerce	29	26	...	...
Transportation	1	3	...	...
Services	8	10	...	...
Other	19	17	...	...

Source: Bank of Lao P.D.R., External Audit Reports.

1/ As of March 10, 2010.

2/ Profit before tax divided by total balance sheet assets.

INTERNATIONAL MONETARY FUND AND
INTERNATIONAL DEVELOPMENT ASSOCIATION

LAO PEOPLE'S DEMOCRATIC REPUBLIC

**Joint IMF/World Bank Debt Sustainability Analysis Under the Debt Sustainability
Framework for Low-Income Countries¹**

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Lao P.D.R.'s risk of debt distress² is still assessed to be high, as two public external debt stock indicators are expected to remain above policy-dependent indicative thresholds over the medium term, notwithstanding the recent downward trend in debt indicators and projected strong growth in the medium term. However, debt service ratios remain comfortably within the policy-dependent indicative thresholds, even under the stress tests, due to the high level of concessionality of official borrowing. Continued prudent debt management, including the management of quasi-fiscal liabilities, as well as cautious assessment and monitoring of large-scale projects will be required to mitigate the risks posed to external and public debt sustainability.

I. BACKGROUND

1. **The results of this DSA are similar to those of the previous DSA³ but the improved outlook for revenue and exports has lowered related debt-burden indicators.** The primary difference between the two is that the present value (PV) of debt to exports ratio no longer exceeds the threshold level beyond the first projection year under the baseline

¹ This DSA was prepared jointly by the IMF and World Bank, in consultation with the Asian Development Bank (AsDB). The debt data underlying this exercise were provided by the Lao P.D.R. authorities.

² The low-income country debt sustainability framework (LIC DSF) recognizes that better policies and institutions allow countries to manage higher levels of debt, and thus the threshold levels for debt indicators are policy-dependent. In the LIC-DSF, the quality of a country's policies and institutions is measured by the World Bank's Country Policy and Institutional Assessment (CPIA) index and classified into three categories: strong, medium, and weak. Lao P.D.R.'s policies and institutions, as measured by the CPIA, averaged 3.21 over the past three years, placing it in the "weak performer" category, defined as countries with a three year average CPIA below or at 3.25. The relevant indicative thresholds for this category are: 30 percent for the PV of debt-to-GDP ratio, 100 percent for the PV of debt-to-exports ratio, 200 percent for the PV of debt-to-revenue ratio, 15 percent for the debt service-to-exports ratio, and 25 percent for the debt service-to-revenue ratio. These thresholds are applicable to public and publicly-guaranteed external debt.

³ IMF Country Report No. 09/284.

scenario. Compared to the previous DSA, the baseline assumptions for economic growth, revenues, and exports are more optimistic, and the projected rate of external debt accumulation is somewhat lower. Longer-term debt dynamics are positively affected by the higher growth, revenue, and exports assumptions and the lower projected rate of debt accumulation. However, the lower discount rate—4 percent, down from 5 percent in the 2009 DSA as a result of lower global interest rates—raises the PV of external debt across the board.

2. Lao P.D.R.’s external public and publicly-guaranteed (PPG) debt stock remains elevated.

The PV of debt at end-2009 was 43 percent of GDP or 129 percent of exports. Strong economic growth, appreciation of the kip, and favorable external conditions contributed to a decline in the ratio of external PPG debt to GDP over the past few years. The stock of external PPG debt declined to 55 percent of GDP at end-2009 from 82 percent of GDP in 2005, but it increased in nominal

terms to US\$3.1 billion from US\$2.2 billion over the same period. The debt of state-owned enterprises (SOEs), to the extent possible, is included into the PPG debt. The private external debt—which totaled 46 percent of GDP at end-2009—is mostly related to projects in mining, hydropower and construction sectors.

	Indicative Thresholds	End-2009
Present value of debt, as a percent of:		
GDP	30	43
Exports	100	129
Revenue	200	283
Debt service, as a percent of:		
Exports	15	5
Revenue	25	11
Source: IMF staff estimates.		

3. Around 66 percent of external PPG debt in Lao P.D.R. is held by multilateral creditors, mainly the Asian Development Bank (AsDB, 37 percent) and the International Development Association (IDA, 22 percent). About 31 percent is held by bilateral creditors—mainly Russia, China, Thailand, and Japan.⁴ Last year India, Korea, and Thailand increased their lending to Lao P.D.R. The remaining 3 percent of PPG external debt comprises external debt incurred by public entities on nonconcessional terms and guaranteed by the government, mainly for hydropower development and electricity generation, including financing equity stakes. The increasing presence of emerging-market creditors underscores the need to strengthen debt management capacity, particularly to ensure that debt sustainability considerations are taken into account when new debt is contracted.

A mitigating factor for Lao P.D.R.’s external debt burden lies in the prospective returns on the hydropower projects that have been financed in part by external PPG debt. While the projects face construction and implementation challenges, the long-term power purchase

⁴ The Soviet-era debt owed to the Russian Federation has been under negotiation since 2007. The Lao P.D.R.’s authorities reported significant progress in the negotiations since last year’s DSA. On this basis, and unlike the no-repayments assumptions used in last year’s DSA, this year’s DSA assumes that the debt to Russia will be serviced from 2011 onward.

agreements that are signed for these projects and resulting government revenues in the form of royalties, dividends, and profit tax payments arguably reduce the risk of debt distress.

4. Domestic public debt, while still relatively small, rose in 2009 as the central bank extended sizable direct credit to local governments.

At end-2009, the stock of recorded domestic public debt amounted to 6.1 percent of GDP, up from 3.0 percent of GDP at end-2008, driven mainly by the Bank of Lao P.D.R.'s (BoL) direct lending to finance local government's off-budget infrastructure projects, which added kip 1,628 billion (US\$192 million or 3.4 percent of GDP) to domestic debt in 2009. Total PPG domestic and external debt stood at 61.5 percent of GDP in 2009. The stock of BoL lending to local governments is expected to peak in 2010, with total commitment of over kip 3 trillion likely fully disbursed by September and repayments from the central government budget kicking in.

	In billions of U.S. Dollars	As a Share of Total External Debt	In percent of GDP
Total	3.1	100	55.5
Multilateral	2.05	66	36.7
Bilateral	0.95	31	17.0
Commercial 1/	0.1	3	1.8

Sources: Lao P.D.R. authorities; and IMF and World Bank staffs' estimates.
1/ Includes direct borrowing by state-owned enterprises on nonconcessional terms.

II. UNDERLYING DEBT SUSTAINABILITY ANALYSIS ASSUMPTIONS

5. Box 1 summarizes the medium-term macroeconomic framework underlying the DSA. Most notably, the baseline scenario—which is based on current policies—projects annual average growth for the next six years at 7.6 percent, in line with the average for the last five years and only slightly below the authorities' growth projections in the draft seventh five-year plan (2011–15). Continuing recent trends, growth would be increasingly supported by large resource (mostly mining and power) projects, some of which are already under development. The economy is also projected to be supported by an expansion of the nontradable sector (tourism and construction), followed by the nonresource tradable sector (agriculture and manufacturing). Stable macroeconomic conditions and continuing reforms to further the transition to a market economy will contribute to steady growth. The recovery of copper prices and strong demand for electricity in neighboring countries are bringing forward expansion plans in mining and hydropower sectors that were delayed in the aftermath of the global financial crisis—hence the upward revision of the growth projections compared to the previous DSA. Activity outside the resource sectors continues to be buoyed by the expansionary fiscal and monetary policies.

III. DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

6. Under the baseline scenario, the three public external debt stock indicators remain above the policy-dependent indicative debt burden thresholds in the first part of

the projection period (Figure 1 and Table 1). Unlike in last year's DSA, mainly reflecting the recovery of copper prices, the PV of debt-to-exports ratio exceeds the threshold level only in 2010 under the baseline scenario. All three external debt stock indicators are projected to be on a declining trend from 2010 onward, reflecting prudent borrowing and strong economic growth. Debt service ratios (both as a share of exports and government revenues) remain well below indicative thresholds throughout the 20-year projection period, despite falling concessionality.

7. **External debt sustainability is most vulnerable to a depreciation of the nominal exchange rate and lower export growth** (Table 3).⁵ Table 3 and Figure 1 illustrate how a one-off 30 percent depreciation of the kip would lead to a sharp rise in the PV of debt-to-GDP and the PV of debt-to-revenue ratios.⁶ A decline in export growth (by one standard deviation in 2011–12) would push the PV of debt-to-exports up to double its baseline level through 2017 and in excess of the policy-dependent indicative threshold throughout the 20-year projection period. The latter scenario illustrates the likely impact of a sharp decline in copper and gold prices on debt sustainability.

8. **Debt dynamics are worse under an alternative scenario in which key variables are at their historical averages especially as FDI flows are expected to accelerate under the baseline** (see Box 1). Through 2014, debt dynamics are more favorable under this “historical scenario” as it takes into account the stronger increase in the GDP deflator in U.S. dollar terms (reflecting the nominal appreciation of the kip) experienced during 2000–2009. In later years, this effect is outweighed by the lower historical average for FDI inflows (3.3 percent of GDP per annum) compared to the higher medium-term baseline assumptions (e.g., 14.8 percent of GDP in 2015), which would require additional debt financing. In case of a significant decline in FDI, all debt stock indicators would remain more elevated and in two of the three cases remain above the relevant indicative thresholds. However, the comparatively optimistic baseline scenario is justified by the government's track record of reforms and macroeconomic stability that has encouraged substantial FDI inflows in recent years.

9. **Lao P.D.R.'s external debt dynamics are highly sensitive to assumptions regarding investment and performance of the resource sector.** Large resource-related projects now account for some 10 percent of GDP, with this share expected to nearly double over the medium term. Under the baseline, the global economic recovery is assumed to result in previously-delayed projects being brought forward as well as the expansion of existing projects.

⁵ The most extreme stress test is defined as the bound test resulting in the most extreme deterioration of the debt burden indicator after 10 years.

⁶ It should be noted that the improved revenue outlook results in a more benign time profile of the PV of debt-to-revenue ratio. In response to a 30 percent depreciation of the nominal exchange rate, the ratio would remain above the indicative threshold over the first half of the projection period as opposed to throughout the projection period in last year's DSA.

The Lao P.D.R. economy remains exposed to fluctuations in international copper and gold prices as well as the economic outlook in neighboring countries (e.g., Thailand, Vietnam, and China). Lower growth in Lao P.D.R. and a weaker balance of payments would obviously worsen debt dynamics. Cautious assessment and monitoring of large-scale projects will be required to mitigate the risks posed to external and public debt sustainability, especially if some of these projects may be financed from commercial sources such as bonds backed by future revenues.

10. **A recent study by the staff of the IMF and the World Bank found that Lao P.D.R. is one of the countries that is currently judged to be at a high risk of debt distress where modest but sustained improvements in policies and institutions could significantly reduce debt vulnerabilities** (see <http://www.imf.org/external/np/pp/eng/2010/040110.pdf>).

Lao P.D.R.'s CPIA score has improved considerably in recent years. A modest further increase would place the country as a "medium performer."

B. Public Sector Debt Sustainability

11. **Under the baseline scenario, the PV of total PPG debt in percent of GDP and in percent of revenue are both projected to decline over the medium term** (Figure 2 and Table 2). This result differs from last year's DSA, which projected an initial rise in the PV of debt to GDP and PV of debt to revenue ratios reflecting a deterioration of the fiscal position and rising quasi-fiscal liabilities. The projected buildup of domestic debt is now smaller,⁷ building on the strong revenue performance in FY2009 and the phasing out of the direct central bank lending to local governments, which contributed importantly to the 7.2 percent of GDP overall fiscal deficit in FY2009. Domestic debt is projected to increase to 6.7 percent of GDP in 2010 from 6.1 percent in 2009 and decline thereafter to 1.8 percent of GDP in 2015.

12. **The debt service-to-GDP ratio is projected to rise in 2011 before tapering off over the remainder of the projection period.** The impact of expiring grace periods and falling concessionality are offset by assumed fiscal adjustment, causing the PV of debt service-to-revenue ratio to decline over the projection period.

13. **Public debt ratios are particularly sensitive to real kip depreciation over the medium term** (Figure 2, Table 4). A one-time 30 percent real depreciation of the kip in 2011 would immediately raise the PV of public debt-to-GDP ratio and the PV of public debt-to-revenue ratio to 64 and 330 percent, respectively, before both indicators taper off. The impact on the debt service-to-revenue ratio is relatively mild, leading to an increase to around 17 percent in 2012; however, the impact would be more sustained over the longer term. It should be noted that this scenario is likely to overstate risks given that a significant share of GDP, including most of the resource GDP, is earned in foreign currency.

⁷ Last year's DSA did not include direct BoL lending in domestic debt. Hence, a comparison with last year's DSA would require some adjustments.

14. **Alternative scenarios point to less positive debt dynamics, especially over the longer term.** The first alternative scenario puts key variables (real GDP growth and the primary balance) at historical averages, and hence primary fiscal deficits about 2 percentage points of GDP higher than in the baseline scenario. In this scenario, the PV of public debt rises above 50 percent of GDP over the longer term (grey dashed line in Figure 2).

The second alternative scenario keeps the primary balance unchanged from the level projected for 2010 (red dashed line in Figure 2). Given that this level is almost identical to the 10-year average of the primary deficit (3.4 percent of GDP) used in the first alternative scenario, it is not surprising that both scenarios result in virtually the same public debt dynamics. Under such circumstances, the debt-to-GDP ratio is put on a rising trajectory indicating the need for fiscal consolidation.

15. **Under the baseline it is assumed that the BoL phases out its quasi-fiscal activities.** During 2009 and so far during 2010, the BoL has played an active role in financing local governments' infrastructure expenditures. Should the envisaged phasing out not materialize, for instance if FDI and ODA come in lower than envisaged in the government's new five-year plan (2011–15) and the government calls again on the BoL to fill the resulting "investment financing gap," the public debt dynamics would be significantly worse.

IV. THE AUTHORITIES' VIEW

16. **The authorities concurred with the overall assessment.** They acknowledged that the relatively high debt level requires fiscal consolidation and a strengthening of debt management. However, the authorities believe that the relatively long maturity profile of the loans and the large share of borrowed resources deployed to viable⁸ natural resource projects significantly mitigate risks of debt distress.

V. CONCLUSION

17. **While Lao P.D.R. has made progress in reducing its external and public debt burden, it still faces a high risk of debt distress.** Debt dynamics reflect current and planned large-scale investments in hydropower and mining projects that will only deliver returns over the medium term. The outlook is particularly sensitive to large swings of the exchange rate, highlighting the importance of maintaining macroeconomic stability and deepening structural reforms. It is also sensitive to fluctuations in exports earnings, and in particular commodity prices. That said, the high level of concessionality of official borrowing keeps debt service ratios relatively contained.

⁸ Viable projects are projects in which the rate of return exceeds the cost of financing or the net present value of future income exceeds the net present value of borrowing.

18. **External borrowing should be obtained on concessional terms and fiscal and quasi-fiscal liabilities should be carefully managed, to further guard against vulnerabilities.**

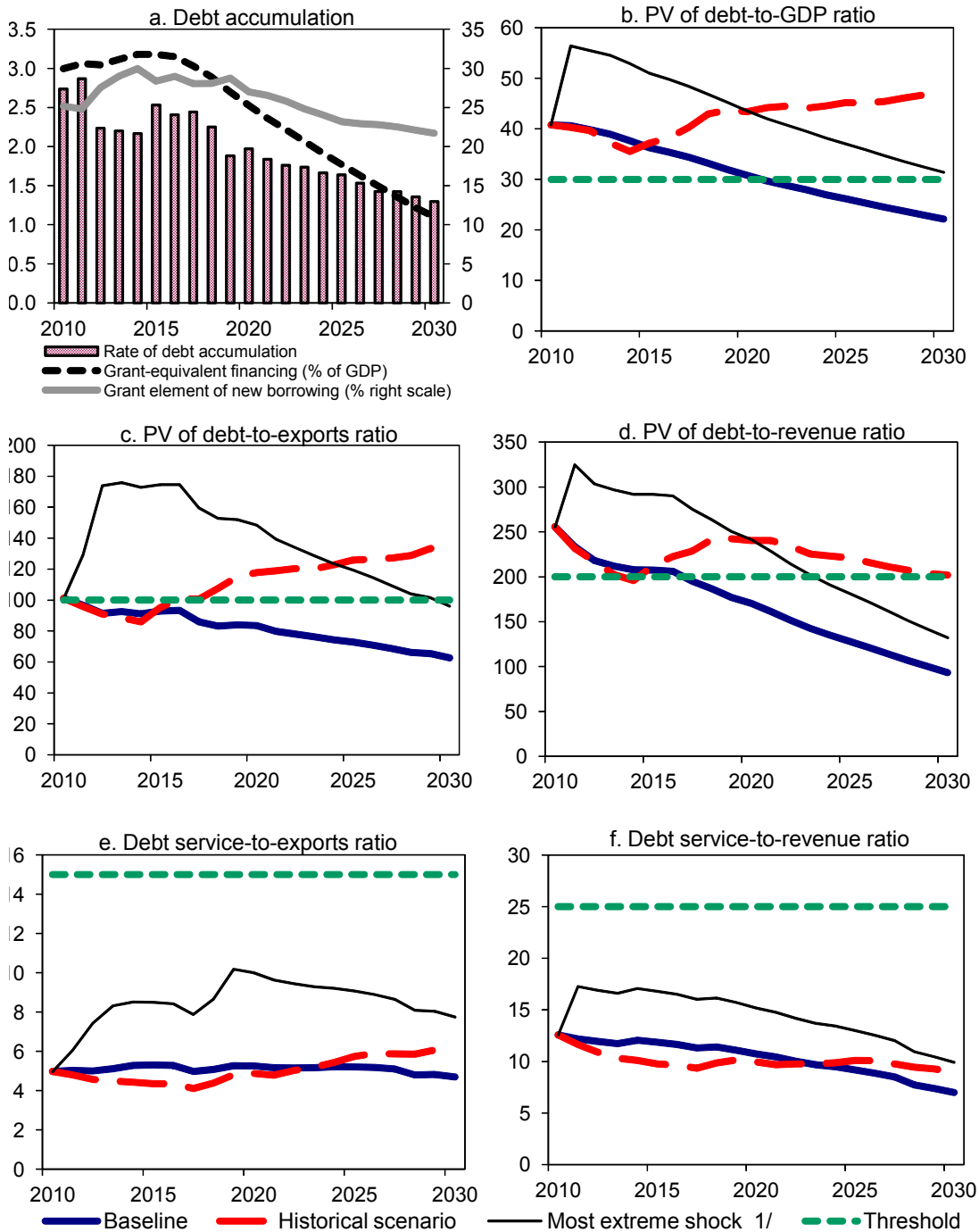
Continued prudent debt management, as well as cautious assessment and monitoring of large-scale projects, will be required to mitigate the risks posed to external and public debt sustainability. Fiscal risk could arise if these projects fail to generate the expected returns, including to the government's own equity stakes. The BoL's planned exit from direct lending to local governments is a welcome development. Improving debt management capacity and developing a medium-term borrowing strategy for the government, including for resource sector activity, as well as greater disclosure of borrowing plans, would substantially enhance the assessment of debt sustainability. In view of the high risk of debt distress, recourse to nonconcessional external financing should be strictly limited to viable projects.

Box 1: Baseline Scenario—Underlying Assumptions (2010–30)

The baseline macroeconomic framework assumes that the economy will be underpinned by further development of Lao P.D.R.'s potential in hydropower and mining, supported by reforms to further the transition to a market economy and a strengthening of macroeconomic policy frameworks.

- **Real GDP growth** is projected to average 7.6 percent in 2010–15 as new resource sector-related projects come on stream. The near-term outlook is boosted by the start of operations of the 1,070 MW Nam Theun II hydropower station in March 2010. Overall growth is relatively volatile as resource sector output is subject to discrete changes as new projects come online or existing mines are exhausted. Over the longer term, assumed structural changes and reforms would create an enabling environment, broadening the sources of growth. Real GDP growth is expected to moderate to 6.6 percent on average in 2016–30 as the resource sector matures. Over time, the share of agriculture in GDP declines, as the transition to a market-based economy leads to an increasing share of industry and services. Graduation from low-income status could be achieved in the second half of the projection period.
- The **copper and gold price** projections through 2015 are based on the WEO projections as of June 2010 and are assumed constant in real terms afterwards.
- **Inflation** is projected to average about 5 percent during 2010–11, as exchange rate stability contains external inflationary pressures. Over the longer term, inflation is expected to moderate to 3 percent.
- The **balance of payments** will go through large swings, reflecting development of the resource sector. The external current account deficit is projected to narrow considerably in the long run. The nonresource current account would deteriorate over the next decade reflecting the increasing cost of industrialization, before moderating over the longer term. This would increasingly be offset by a shift to surplus in the resource current account as large projects transition from construction to operation phase. The assumed pick up in nonresource exports and services is driven by strengthened competitiveness and regional integration, supported by improvements in the investment climate, a streamlining of business regulations, and meeting trade commitments. Notwithstanding its recent weakening, the overall external position is expected to strengthen over time, reflecting strong private capital and official inflows, and increasing international reserve accumulation in the outer years as the resource sector matures and industrialization takes hold. Private capital inflows in the form of FDI are expected to increase through the first half of the projection period as large new projects get underway.
- **External financing** is assumed to remain largely on concessional terms over the medium term. Over the long term, grant financing decreases with economic development.
 - **Multilateral creditors:** Projected loan disbursements in the medium term are relatively low since IDA and the AsDB have a pipeline of operations financed on grant terms. Over the longer term, grant financing decreases with economic development, leading once again to a moderate increase in project loans.
 - **Bilateral creditors:** For 2010–11, projected loan disbursements increase as donors provide support to the government's development agenda. Over the medium and longer term, greater participation by new emerging market creditors leads bilateral finance to take on an increasing role, including for onlending purposes to SOEs.
 - **Commercial creditors:** Over the medium term, commercial disbursements are relatively small, principally used to finance a portion of the government's equity stake participation in new hydropower projects. The US\$70 million bond issue backed by royalties from the Theun-Hinboun and Houay Ho projects has been repeatedly postponed and is not assumed to materialize in the current DSA. The 2011 debt projection assumes government's borrowing to finance its equity stake in the Hongsa Lignite project (coal mine and power plant).
- **Fiscal policy** is projected to remain on a consolidation path from the 7.2 percent of GDP overall deficit recorded in FY09. The deficit is projected to narrow to about 4.9 percent of GDP in FY10 and to decline further in subsequent years. The consolidation is expected to be supported by rising resource sector revenues thanks to strong commodity prices.
- **Domestic debt** decreases over the medium term driven by repayments of the lending from the BoL. It increases in the long term as net external financing in percent of GDP declines and a larger share of budget deficits is financed domestically.

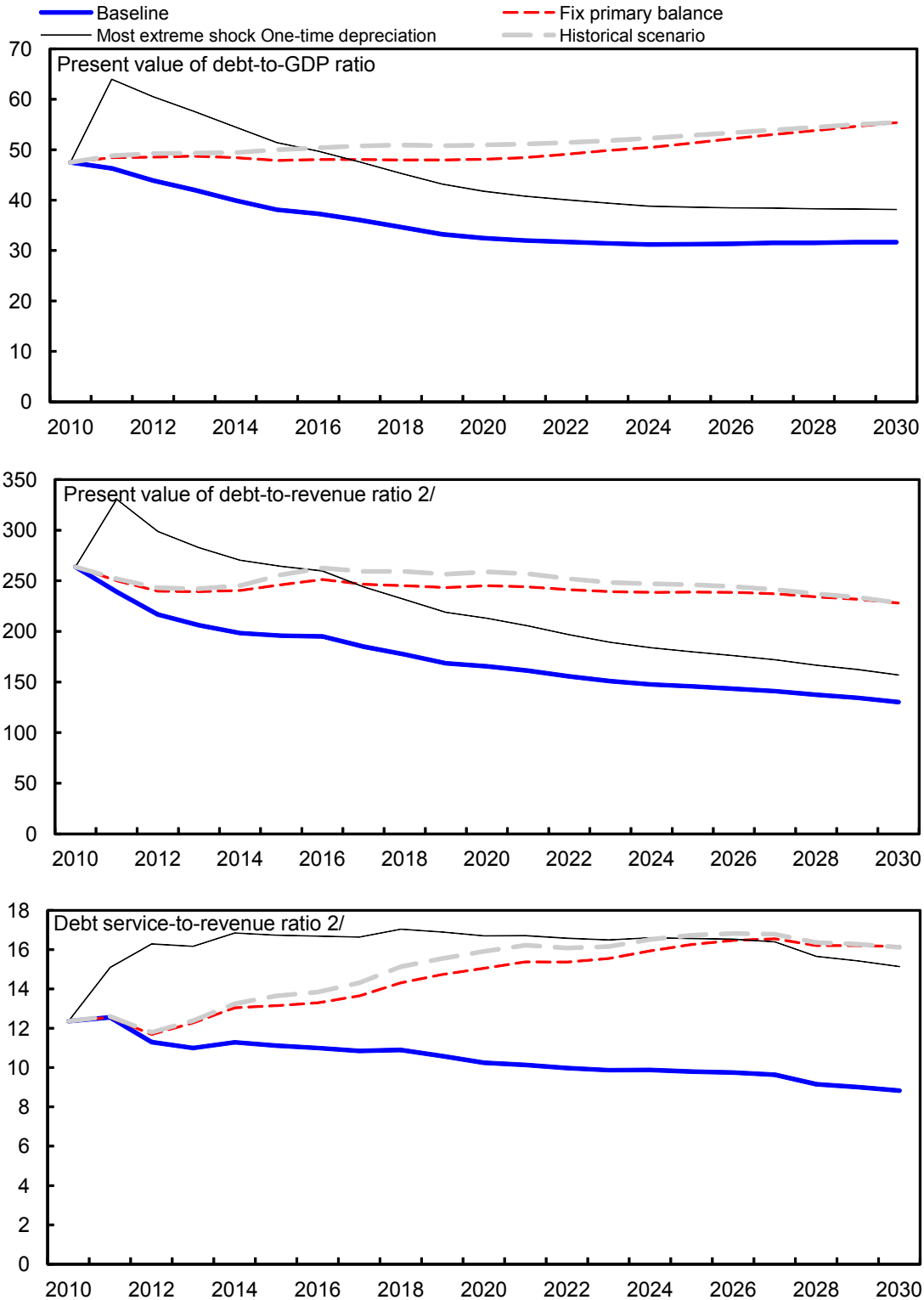
Figure 1. Lao P.D.R.: Indicators of Public and Publicly-Guaranteed External Debt Under Alternative Scenarios, 2010–30 1/



Sources: Lao P.D.R. authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2020. In figure b. it corresponds to a One-time depreciation shock; in c. to an Exports shock; in d. to a One-time depreciation shock; in e. to an Exports shock; and in figure f. to a One-time depreciation shock.

Figure 2. Lao P.D.R.: Indicators of Public Debt Under Alternative Scenarios, 2010–30 1/



Sources: Lao P.D.R. authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2020.

2/ Revenues are defined inclusive of grants.

Table 1. Lao P.D.R.: External Debt Sustainability Framework, Baseline Scenario, 2007–30 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 1/	Standard Deviation 1/	Projections									
	2007	2008	2009			2010	2011	2012	2013	2014	2015	2010–15 Average	2020	2030	2016–30 Average
External debt (nominal) 2/	100.6	96.4	101.5			91.5	92.1	94.6	99.1	102.3	98.8		79.7	49.2	
<i>Of which: Public and publicly-guaranteed (PPG)</i>	58.2	54.0	55.4			51.5	51.0	49.9	48.7	47.3	45.6		39.0	27.9	
Change in external debt	7.4	-4.3	5.1			-10.0	0.6	2.5	4.5	3.2	-3.5		-3.6	-2.7	
Identified net debt-creating flows	-0.4	-11.0	4.8			-3.5	1.1	0.9	4.5	3.1	-3.5		0.5	-1.9	
Noninterest current account deficit	14.6	17.4	16.4	11.4	6.4	8.1	11.6	13.5	18.2	24.1	18.4		12.2	6.2	9.9
Noninterest current account deficit	15.0	16.8	16.2			8.7	11.9	13.8	18.5	24.8	19.4		10.5	1.9	
Exports	37.8	38.0	33.6			40.3	42.1	43.6	42.1	41.3	39.1		36.8	35.4	
Imports	52.9	54.8	49.8			49.0	54.0	57.4	60.6	66.1	58.5		47.3	37.3	
Net current transfers (negative = inflow)	-2.5	-2.7	-2.3	-3.6	1.9	-2.7	-2.8	-2.8	-2.8	-2.8	-2.8		-2.4	-1.9	-2.3
<i>Of which: Official</i>	-1.3	-1.5	-1.7			-2.0	-2.0	-2.0	-2.0	-2.0	-2.0		-1.6	-0.6	
Other current account flows (negative = net inflow)	2.0	3.2	2.5			2.0	2.4	2.5	2.4	2.1	1.8		4.2	6.2	
Net FDI (negative = inflow)	-1.7	-8.9	-7.8	-3.3	3.0	-6.9	-6.2	-8.2	-9.8	-15.8	-14.8		-8.0	-6.2	-7.7
Endogenous debt dynamics 3/	-13.3	-19.5	-3.7			-4.7	-4.3	-4.4	-3.9	-5.2	-7.1		-3.7	-1.9	
Contribution from nominal interest rate	1.3	1.1	1.2			2.1	2.0	1.9	1.7	1.7	1.5		1.5	1.0	
Contribution from real GDP growth	-6.2	-6.2	-6.9			-6.9	-6.3	-6.3	-5.6	-6.9	-8.6		-5.3	-2.8	
Contribution from price and exchange rate changes	-8.4	-14.4	2.0			...	...	...	...	...	...		...	...
Residual (3–4) 4/	7.8	6.7	0.3			-6.5	-0.5	1.6	0.0	0.1	0.0		-4.1	-0.8	
<i>Of which: exceptional financing</i>	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Present value (PV) of external debt 5/	...	...	89.5			80.7	81.7	84.5	89.3	92.7	89.4		71.5	43.5	
PV of external debt 5/	...	...	266.0			200.3	194.3	193.9	212.1	224.2	228.9		194.1	122.9	
PV of PPG external debt	...	...	43.4			40.8	40.6	39.8	39.0	37.7	36.3		30.8	22.2	
In percent of exports	...	...	129.0			101.2	96.6	91.4	92.5	91.2	92.8		83.5	62.6	
In percent of government revenues	...	...	282.6			255.7	233.9	218.1	212.1	207.7	207.7		170.5	93.4	
Debt service-to-exports ratio (in percent)	12.5	10.4	15.6			16.2	14.0	12.6	14.7	14.8	13.8		18.1	12.8	
PPG debt service-to-exports ratio (in percent)	4.0	4.3	5.0			5.0	5.0	5.0	5.1	5.3	5.3		5.3	4.7	
PPG debt service-to-revenue ratio (in percent)	10.8	11.4	11.0			12.6	12.2	11.9	11.7	12.1	11.9		10.7	7.0	
Total gross financing need (in billions of U.S. dollars)	0.7	0.7	0.8			0.5	0.8	0.8	1.2	1.3	0.9		1.7	1.7	
Noninterest current account deficit that stabilizes debt ratio	7.1	21.6	11.2			18.1	11.0	11.0	13.7	20.9	21.9		15.8	8.9	
Key macroeconomic assumptions															
Real GDP growth (in percent)	7.8	7.8	7.6	7.0	1.2	7.7	7.5	7.3	6.4	7.6	9.3	7.6	7.0	6.0	6.6
GDP deflator in U.S. dollar terms (change in percent)	9.9	16.6	-2.1	7.4	8.2	5.2	2.0	0.0	0.9	1.2	1.4	1.8	3.0	3.0	2.8
Effective interest rate (percent) 6/	1.6	1.4	1.3	1.7	0.3	2.4	2.4	2.2	2.0	1.9	1.6	2.1	2.0	2.1	1.9
Growth of exports of G&S (U.S. dollar terms, in percent)	18.7	26.3	-6.8	16.2	21.1	35.8	14.5	11.2	3.7	6.9	4.8	12.8	6.8	10.3	8.8
Growth of imports of G&S (U.S. dollar terms, in percent)	34.2	30.4	-4.3	17.4	14.0	11.6	20.7	14.1	13.4	18.7	-2.0	12.8	5.6	7.6	6.3
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	25.2	24.8	27.5	29.0	30.0	28.4	27.5	27.0	21.7	25.2
Government revenues (excluding grants, in percent of GDP)	14.1	14.3	15.3	...	...	15.9	17.4	18.3	18.4	18.1	17.5	...	18.0	23.8	19.8
Aid flows (in billions of U.S. dollars) 7/	0.1	0.1	0.1	...	...	0.2	0.2	0.2	0.3	0.3	0.3	...	0.4	0.4	...
<i>Of which: Grants</i>	0.1	0.1	0.1	...	...	0.1	0.1	0.1	0.2	0.2	0.2	...	0.2	0.2	...
<i>Of which: Concessional loans</i>	0.0	0.0	0.0	...	...	0.1	0.0	0.1	0.1	0.1	0.1	...	0.2	0.2	...
Grant-equivalent financing (in percent of GDP) 8/	...	...	...	...	...	3.0	3.1	3.0	3.1	3.2	3.2	...	2.5	1.1	2.1
Grant-equivalent financing (in percent of external financing) 8/	...	...	...	...	...	51.6	48.6	52.3	53.2	53.6	51.4	...	49.6	35.4	45.2
Memorandum items:															
Nominal GDP (in billions of U.S. dollars)	4.2	5.3	5.6	...	...	6.3	7.0	7.5	8.0	8.7	9.7	...	15.4	37.8	...
Nominal dollar GDP growth	18.6	25.7	5.4	...	...	13.3	9.7	7.3	7.3	8.9	10.8	9.6	10.2	9.1	9.5
PV of PPG external debt (in billions of U.S. dollars)	...	...	2.4	...	...	2.6	2.8	2.9	3.1	3.3	3.5	...	4.7	8.4	...
(PVt-PVt-1)/GDPt-1 (in percent)	...	...	...	...	...	2.7	2.9	2.2	2.2	2.2	2.5	2.5	2.0	1.3	1.8
Gross remittances (in billions of U.S. dollars)	0.1	0.1	0.0	...	...	0.0	0.1	0.1	0.1	0.1	0.1	...	0.1	0.5	...
PV of PPG external debt (in percent of GDP + remittances)	...	...	43.1	...	...	40.5	40.3	39.5	38.7	37.4	36.0	...	30.5	21.9	...
PV of PPG external debt (in percent of exports + remittances)	...	...	126.6	...	...	99.5	94.9	89.8	90.8	89.4	91.0	...	81.7	60.4	...
Debt service of PPG external debt (in percent of exports + remittances)	...	...	4.9	...	...	4.9	4.9	4.9	5.0	5.2	5.2	...	5.1	4.5	...

Sources: Lao P.D.R. authorities; and staff estimates and projections.

1/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

2/ Includes both public and private sector external debt. The years in the table refer to calendar years.

3/ Derived as $[r - g - \rho(1+g)] / (1+g+\rho+g)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

4/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections, also includes contribution from price and exchange rate changes.

5/ Assumes that PV of private sector debt is equivalent to its face value.

6/ Current-year interest payments divided by previous period debt stock.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 2. Lao P.D.R.: Public Sector Debt Sustainability Framework, Baseline Scenario, 2007–30

(In percent of GDP, unless otherwise indicated)

	Actual			Average 1/	Standard Deviation 1/	Projections									
	2007	2008	2009			2010	2011	2012	2013	2014	2015	2010–15 Average	2020	2030	2016–30 Average
Public sector debt 2/	59.8	57.0	61.5			58.3	56.7	53.9	51.8	49.5	47.4		40.7	37.3	
<i>Of which:</i> Foreign-currency denominated	58.2	54.0	55.4			51.5	51.0	49.9	48.7	47.3	45.6		39.0	27.9	
Change in public sector debt	-4.8	-2.9	4.5			-3.2	-1.6	-2.8	-2.2	-2.2	-2.1		-1.1	-0.2	
Identified debt-creating flows	-6.3	-8.5	4.9			-2.9	-2.2	-2.8	-2.3	-2.4	-2.7		-1.7	-0.9	
Primary deficit	2.2	3.2	6.1	3.4	1.3	3.2	1.0	0.5	0.8	1.0	1.3	1.3	1.4	1.2	
Revenue and grants	15.8	16.0	17.6			18.0	19.4	20.3	20.4	20.1	19.5		19.6	24.3	
<i>Of which:</i> Grants	1.7	1.7	2.3			2.1	2.0	2.0	2.0	2.0	2.0		1.6	0.5	
Primary (noninterest) expenditure	17.9	19.2	23.7			21.2	20.3	20.7	21.2	21.2	20.7		21.0	25.5	
Automatic debt dynamics	-8.4	-11.6	-0.9			-6.1	-3.2	-3.3	-3.2	-3.5	-4.0		-3.1	-2.1	
Contribution from interest rate/growth differential	-5.8	-4.9	-3.9			-4.0	-3.9	-4.0	-3.4	-3.6	-4.1		-2.6	-1.7	
<i>Of which:</i> Contribution from average real interest rate	-1.1	-0.5	0.1			0.3	0.1	-0.2	-0.1	0.0	0.1		0.2	0.4	
<i>Of which:</i> Contribution from real GDP growth	-4.7	-4.3	-4.0			-4.4	-4.1	-3.9	-3.2	-3.7	-4.2		-2.7	-2.1	
Contribution from real exchange rate depreciation	-2.6	-6.7	3.0			-2.1	0.8	0.7	0.2	0.2	0.1		...	...
Other identified debt-creating flows	0.0	-0.1	-0.3			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	-0.1	-0.3			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	1.5	5.7	-0.4			-0.3	0.6	0.1	0.2	0.2	0.6		0.7	0.7	
Other sustainability indicators	...	...	49.4			47.5	46.3	43.9	42.0	39.9	38.1		32.5	31.7
<i>Of which:</i> Foreign-currency denominated	...	...	43.4			40.8	40.6	39.8	39.0	37.7	36.3		30.8	22.2
<i>Of which:</i> External	...	...	43.4			40.8	40.6	39.8	39.0	37.7	36.3		30.8	22.2
<i>Of which:</i> External	...	...	...			...	...	...	...	...	...		...	...
Gross financing need 3/	4.5	5.6	8.9			6.0	3.6	3.2	3.4	3.7	3.9		3.9	7.3	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	280.9			263.9	239.2	216.7	206.2	198.4	195.7		165.4	130.3
PV of public sector debt-to-revenue ratio (in percent)	...	...	322.1			297.8	266.6	240.3	228.6	220.2	218.0		179.9	133.3
<i>Of which:</i> External 4/	...	...	282.6			255.7	233.9	218.1	212.1	207.7	207.7		170.5	93.4
Debt service-to-revenue and grants ratio (in percent) 5/	10.3	11.1	10.3			12.4	12.6	11.3	11.0	11.3	11.1		10.2	8.8	
Debt service-to-revenue ratio (in percent) 5/	11.6	12.5	11.9			14.0	14.0	12.5	12.2	12.5	12.4		11.1	9.0	
Primary deficit that stabilizes the debt-to-GDP ratio	7.0	6.1	1.6			6.4	2.6	3.2	3.0	3.3	3.4		2.4	1.4	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	7.8	7.8	7.6	7.0	1.2	7.7	7.5	7.3	6.4	7.6	9.3	7.6	7.0	6.0	
Average nominal interest rate on forex debt (in percent)	0.8	1.0	0.9	0.8	0.2	1.6	1.6	1.8	1.8	2.0	1.9	1.8	1.9	2.1	
Average real interest rate on domestic debt (in percent)	3.0	3.9	9.5	13.2	13.1	-0.8	1.1	-1.5	-1.4	0.1	1.5	-0.2	3.1	2.9	
Real exchange rate depreciation (in percent, + indicates depreciation)	-4.6	-12.6	5.9	-4.4	9.0	-4.0	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	4.3	6.0	-4.3	8.1	5.7	4.9	4.1	3.8	3.7	3.1	2.9	3.7	3.0	3.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	0.2	0.2	0.3	0.1	0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	
Grant element of new external borrowing (in percent)	...	...	...	...	...	25.2	24.8	27.5	29.0	30.0	28.4	27.5	27.0	21.7

Sources: Lao P.D.R. authorities; and staff estimates and projections.

1/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

2/ The public sector debt represents general government gross debt. The fiscal year for Lao P.D.R. is October–September, but the DSA is done based on calendar year data.

3/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

4/ Revenues excluding grants.

5/ Debt service is defined as the sum of interest and amortization of medium- and long-term debt.

Table 3. Lao P.D.R.: Sensitivity Analysis for Key Indicators of Public and Publicly-Guaranteed External Debt, 2010–30
(In percent)

	Projections							2020	2030
	2010	2011	2012	2013	2014	2015			
Present value of debt-to-GDP ratio									
Baseline	41	41	40	39	38	36	31	22	
A. Alternative scenarios									
A1. Key variables at their historical averages in 2010–30 1/	41	40	40	37	36	37	43	48	
A2. New public sector loans on less favorable terms in 2010–30 2/	41	41	41	41	41	41	38	33	
B. Bound tests									
B1. Real GDP growth at historical average minus one standard deviation in 2011–12	41	40	40	40	38	37	32	23	
B2. Export value growth at historical average minus one standard deviation in 2011–12 3/	41	45	54	53	51	49	39	24	
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2011–12	41	41	41	40	39	37	32	23	
B4. Net nondebt creating flows at historical average minus one standard deviation in 2011–12 4/	41	45	51	50	48	46	37	24	
B5. Combination of B1–B4 using one-half standard deviation shocks	41	45	52	51	49	47	38	24	
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	41	56	55	55	53	51	44	31	
Present value of debt-to-exports ratio									
Baseline	101	97	91	93	91	93	84	63	
A. Alternative scenarios									
A1. Key variables at their historical averages in 2010–30 1/	101	96	91	88	86	95	118	135	
A2. New public sector loans on less favorable terms in 2010–30 2/	101	97	94	98	100	104	104	92	
B. Bound tests									
B1. Real GDP growth at historical average minus one standard deviation in 2011–12	101	95	90	91	90	92	83	63	
B2. Export value growth at historical average minus one standard deviation in 2011–12 3/	101	129	174	176	173	175	148	96	
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2011–12	101	95	90	91	90	92	83	63	
B4. Net nondebt creating flows at historical average minus one standard deviation in 2011–12 4/	101	107	117	118	116	118	101	67	
B5. Combination of B1–B4 using one-half standard deviation shocks	101	117	140	142	139	141	120	78	
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	101	95	90	91	90	92	83	63	
Present value of debt-to-revenue ratio									
Baseline	256	234	218	212	208	208	171	93	
A. Alternative scenarios									
A1. Key variables at their historical averages in 2010–30 1/	256	232	217	203	196	213	240	202	
A2. New public sector loans on less favorable terms in 2010–30 2/	256	235	225	226	227	232	213	137	
B. Bound tests									
B1. Real GDP growth at historical average minus one standard deviation in 2011–12	256	233	221	216	212	212	175	96	
B2. Export value growth at historical average minus one standard deviation in 2011–12 3/	256	260	295	287	280	278	216	102	
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2011–12	256	236	222	217	214	214	177	97	
B4. Net nondebt creating flows at historical average minus one standard deviation in 2011–12 4/	256	259	279	271	265	264	206	100	
B5. Combination of B1–B4 using one-half standard deviation shocks	256	262	286	278	272	269	209	99	
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	256	325	304	297	292	292	241	132	

Table 3. Lao P.D.R.: Sensitivity Analysis for Key Indicators of Public and Publicly-Guaranteed External Debt, 2010–30 (concluded)
(In percent)

	Projections							
	2010	2011	2012	2013	2014	2015	2020	2030
Debt service-to-exports ratio								
Baseline	5	5	5	5	5	5	5	5
A. Alternative scenarios								
A1. Key variables at their historical averages in 2010–30 1/	5	5	5	4	4	4	5	6
A2. New public sector loans on less favorable terms in 2010–30 2/	5	5	5	5	6	6	7	7
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2011–12	5	5	5	5	5	5	5	5
B2. Export value growth at historical average minus one standard deviation in 2011–12 3/	5	6	7	8	9	9	10	8
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2011–12	5	5	5	5	5	5	5	5
B4. Net nondebt creating flows at historical average minus one standard deviation in 2011–12 4/	5	5	5	6	6	6	7	5
B5. Combination of B1–B4 using one-half standard deviation shocks	5	5	6	7	7	7	8	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	5	5	5	5	5	5	5	5
Debt service-to-revenue ratio								
Baseline	13	12	12	12	12	12	11	7
A. Alternative scenarios								
A1. Key variables at their historical averages in 2010–30 1/	13	12	11	10	10	10	10	9
A2. New public sector loans on less favorable terms in 2010–30 2/	13	12	12	12	13	13	14	10
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2011–12	13	12	12	12	12	12	11	7
B2. Export value growth at historical average minus one standard deviation in 2011–12 3/	13	12	13	14	14	14	15	8
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2011–12	13	13	12	12	12	12	11	7
B4. Net nondebt creating flows at historical average minus one standard deviation in 2011–12 4/	13	12	13	13	13	13	14	8
B5. Combination of B1–B4 using one-half standard deviation shocks	13	12	12	13	13	13	14	8
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	13	17	17	17	17	17	15	10
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	24	24	24	24	24	24	24	24

Sources: Lao P.D.R. authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), noninterest current account in percent of GDP, and nondebt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 4. Lao P.D.R.: Sensitivity Analysis for Key Indicators of Public Debt 2010–30

	Projections							
	2010	2011	2012	2013	2014	2015	2020	2030
Present value of debt-to-GDP ratio								
Baseline	47	46	44	42	40	38	32	32
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	47	49	49	49	49	50	51	55
A2. Primary balance is unchanged from 2010	47	48	49	49	48	48	48	55
A3. Permanently lower GDP growth 1/	47	46	44	43	41	39	35	41
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2011–12	47	47	46	44	43	41	37	40
B2. Primary balance is at historical average minus one standard deviations in 2011–12	47	50	51	49	47	44	37	34
B3. Combination of B1–B2 using one half standard deviation shocks	47	50	51	49	47	45	39	39
B4. One-time 30 percent real depreciation in 2011	47	64	61	58	54	51	42	38
B5. 10 percent of GDP increase in other debt-creating flows in 2011	47	56	53	51	48	46	38	35
Present value of debt-to-revenue ratio 2/								
Baseline	264	239	217	206	198	196	165	130
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	264	252	243	242	245	256	259	228
A2. Primary balance is unchanged from 2010	264	250	240	239	241	246	245	228
A3. Permanently lower GDP growth 1/	264	240	218	209	202	201	179	167
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2011–12	264	244	226	218	212	212	189	163
B2. Primary balance is at historical average minus one standard deviations in 2011–12	264	257	253	241	232	229	190	142
B3. Combination of B1–B2 using one half standard deviation shocks	264	256	251	241	233	231	199	159
B4. One-time 30 percent real depreciation in 2011	264	330	299	283	270	264	213	157
B5. 10 percent of GDP increase in other debt-creating flows in 2011	264	288	262	250	240	236	195	144
Debt service-to-revenue ratio 2/								
Baseline	12	13	11	11	11	11	10	9
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	12	13	12	12	13	14	16	16
A2. Primary balance is unchanged from 2010	12	13	12	12	13	13	15	16
A3. Permanently lower GDP growth 1/	12	13	11	11	11	11	11	11
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2011–12	12	13	12	11	12	12	12	11
B2. Primary balance is at historical average minus one standard deviations in 2011–12	12	13	12	13	13	12	13	10
B3. Combination of B1–B2 using one half standard deviation shocks	12	13	12	13	13	13	13	11
B4. One-time 30 percent real depreciation in 2011	12	15	16	16	17	17	17	15
B5. 10 percent of GDP increase in other debt-creating flows in 2011	12	13	13	15	13	13	13	10

Sources: Lao P.D.R. authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the Asia and Pacific Department
(In Consultation with Other Departments)

July 14, 2010

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ANNEX I. LAO P.D.R.: FUND RELATIONS
(As of June 30, 2010)

I. **Membership Status:** Joined 7/05/61; Article VIII

II. General Resources Account:	SDR million	Percent Quota
Quota	52.90	100.00
Fund holdings of currency	52.90	100.00

III. SDR Department:	SDR million	Percent Allocation
Net cumulative allocation	50.68	100.00
Holdings	51.07	100.78

IV. Outstanding Purchases and Loans:	SDR million	Percent Quota
PRGF Arrangements	8.15	15.41

V. **Latest Financial Arrangements:**

	Approval	Expiration	Amount	Amount
Type	Date	Date	Approved	Drawn
			(SDR million)	(SDR million)
PRGF	4/25/01	4/24/05	31.70	18.12
PRGF	6/04/93	5/07/97	35.19	35.19
SAF	9/18/89	9/17/92	20.51	20.51

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2010	2011	2012	2013	2014
Principal	1.81	3.17	2.27	0.91	0.00
Charges/interest	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>
Total	1.81	3.17	2.27	0.91	0.00

VII. **Implementation of Heavily Indebted Poor Countries Initiative (HIPC)**

Not applicable

VIII. **Implementation of Multilateral Debt Relief Initiative (MDRI):**

Not applicable

IX. Safeguards Assessments

A safeguards assessment of the Bank of Lao P.D.R. (BoL) was completed in April 2003 in the context of an ECF arrangement (Country Report Nos. 03/308 and 05/08). Progress on implementing the safeguards assessment recommendations has been slow. The authorities indicated that they were not in a position to implement an earlier agreement to undertake a joint audit of the BoL's 2003 and 2004 accounts by the state auditor and an international audit firm. The state auditor has since completed these audits, but the joint audit issue remains unresolved.

X. Exchange Arrangement

The de jure regime is a managed float. The de facto regime is stabilized. The BoL sets a daily official reference rate, which is calculated as a weighted average of the previous day's interbank rates. Commercial banks and foreign exchange bureaus are required to maintain their buying and selling rates within ± 0.25 percent of the BoL's daily reference rate for the U.S. dollar. For the euro and baht, the buying and selling rates may not exceed a margin of 0.5 percent and for other currencies, a margin of 2 percent applies.

On May 28, 2010, Lao P.D.R. accepted the obligations under Article VIII, Section 2, 3, and 4, following the elimination of one restriction subject to Fund jurisdiction under Article VIII arising from a requirement to obtain tax payment certificates for some transactions. Lao P.D.R. now maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for restrictions imposed solely for the preservation of national or international security notified to the Fund pursuant to Decision No. 144-(52/51).

XI. Last Article IV Consultation Discussions

The last Article IV consultation discussions were held in Vientiane during May 13–27, 2009. The staff report (Country Report No. 09/284) was discussed by the Executive Board on July 10, 2009 and was published on September 11, 2009.

XII. Technical Assistance During the Past 18 Months

STA: Government Finance Statistics (May 2009)
 FAD: Peripatetic expert in customs administration

XIII. Resident Representative

Mr. Benedict Bingham assumed the Senior Resident Representative post for Vietnam and Lao P.D.R., based in Hanoi, on October 17, 2007. The IMF's local office in Vientiane was closed in July 2010. Contacts with the authorities are henceforth handled by the Hanoi office.

ANNEX II. LAO P.D.R.: RELATIONS WITH THE WORLD BANK GROUP¹

The Bank's country partnership with the Lao P.D.R. is guided by a country assistance strategy (CAS), which comprises of four pillars: sustaining growth, improving social outcomes, capacity development and partnerships, and supporting Nam Theun 2 (NT2) implementation. The initial CAS for Lao P.D.R. was approved on March 31, 2005, along with two flagship operations for the Lao P.D.R.: the first Poverty Reduction Support Operation (PRSO-1) and the NT2 hydroelectric project. On May 4, 2007, the Bank board approved an extension of the initial CAS period (FY05–FY07) by two years, to end in FY11.

CAS Pillar 1: Sustaining Growth

The Bank group's engagement under Pillar 1 aimed at private sector development, improved access to finance, and widening of trade opportunities. Major operations in FY08–FY11 comprised of (i) trade facilitation projects; (ii) financial sector projects—for example, IFC investment in private banks, IFC advisory work on credit infrastructure, and support on the commercial banking law implementation; (iii) a continued, sharply-focused PRSO series; (iv) and Greater Mekong Subregion (GMS) Power, Water, and Trade Projects.

CAS Pillar 2: Improving Social Outcomes

The Bank continues to focus on public finance management (PFM). Priorities are (i) supporting the government's efforts to establish a more transparent and equitable inter-governmental fiscal transfer system; (ii) assisting centralization of the national treasury in a bid to improve execution, disclosure, monitoring, and management of the budget; and (iii) determining priority programs for health and education sectors, rural roads, and environmental conservation. Advisory services on tax reform and tax simplification is also provided, and the engagement in works in areas such as external auditing and public procurement is being strengthened.

CAS Pillar 3: Strategic Approach to Capacity Development and Partnerships

The Bank provides support to the Public Administration and Civil Service Authority (PACSA) in civil service reform. The IFC is also advising the government on small scale rural electrification. The IDA continues to provide practical and operational support toward enhancing aid effectiveness, and the Bank will engage more systematically with stakeholders, promoting community participation and information sharing, particularly through a planned multi-donor Public Information Center.

¹ Prepared by the staff of the World Bank. Contact person: Ms. Geneviève Boyreau, Senior Economist, Poverty Reduction and Economic Management Department, East Asia and Pacific Region, email: gboyreau@worldbank.org.

CAS Pillar 4: Supporting Nam Theun 2 Implementation

The focus is to help Lao P.D.R. to maximize opportunities, while containing risks, brought by mushrooming investment proposals in the hydro and mining sectors, following the NT2 approval. Toward this end, the Bank advises that natural resource management focus more on the quality of investments, macroeconomic and governance implications of natural resource revenue growth, and sustainability of the exploitation. The Bank is deepening its work in natural resource management with a proposed Country Economic Memorandum. Technical assistance is also being undertaken, with the newly approved Hydro and Mining Sector Technical Assistance Project. A partnership in hydro power with the private sector is also being explored through equity participation and guarantees (MIGA, IFC).

IMF-World Bank Group Collaboration

The IMF takes the lead in advising the government on macroeconomic policy. The World Bank Group takes the lead in supporting the government to formulate a growth and poverty reduction strategy and implementing structural reforms.

IDA: Commitments and Disbursements to Lao P.D.R., 1977–2009				
(In millions of U.S. dollars)				
Fiscal Year (to June 30)	Committed	Disbursed	Repayments 1/	
1977–93	335.2	180.7	1.5	
1994	48.4	45.1	0.6	
1995	19.2	31.4	0.6	
1996	60.7	28.6	0.6	
1997	48.0	65.2	0.6	
1998	34.7	26.5	1.3	
1999	29.8	27.8	1.5	
2000	0.0	18.1	3.0	
2001	41.7	29.9	3.6	
2002	44.8	30.5	4.9	
2003	24.7	41.2	6.1	
2004	35.7	46.7	7.3	
2005	76.0	36.0	8.4	
2006	37.0	36.3	8.7	
2007	28.0	53.4	9.6	
2008	25.0	50.9	12.5	
2009	28.0	32.5	13.4	
Total	916.9	780.8	84.2	

1/ Note: repayments include principal repayments and do not include commitment or service charges.

ANNEX III. LAO P.D.R.: RELATIONS WITH THE ASIAN DEVELOPMENT BANK²

The Asian Development Bank (AsDB)'s current Country Strategy and Program (CSP) 2007–11 is aligned with the government's development strategy (National Socio-Economic Development Plan (NSEDP)), and seeks to promote pro-poor sustainable growth, social inclusiveness, and improved governance. A mid-term review of the CSP, completed in August 2009, confirmed that the CSP's strategic thrusts remain valid and in line with the government's priorities. The AsDB is currently preparing its next country partnership strategy for the period 2012–16. The CSP will be designed to support the seventh NSEDP implementation.

At the Third Greater Mekong Subregion (GMS) Summit, the GMS leaders discussed ways to deepen economic cooperation and improve connectivity to expand markets, improve access to social services, and protect the environment. The AsDB aims to maximize benefits from this cooperation and the CSP aims to foster connectivity, promote large-scale foreign direct investment, and create regional public goods. The AsDB will focus primarily on the poor northern provinces and the East-West corridor that links Thailand to Lao P.D.R. and Vietnam.

The net resource transfer from the AsDB to Lao P.D.R was negative US\$5.9 million in 2009, from US\$13.8 million in 2008. The national loan/grant pipeline for 2009–12 indicates a US\$20 million increase from 2005–08 to about US\$60 million annually. Support through subregional operations (GMS) has similarly increased from an annual average of US\$16 million to US\$85 million. The active technical assistance (TA) portfolio at the end of March 2010 comprised a total of 21 TA projects amounting to US\$15.4 million, excluding regional TAs.

Since 2007, AsDB program operations shifted to 100 percent grant. Five new grants in total of US\$102.8 million were approved in 2009, comprising of sustainable natural resources management and productivity enhancement project, small towns water supply and sanitation, strengthening higher education project, private sector and SME development program, and health sector development program. In 2010, the AsDB expects to approve four projects (US\$37.6 million), five GMS projects (US\$99.0 million), and 11 TA projects (US\$7.6 million).

Lao P.D.R.: Asian Development Bank Commitments and Disbursements, 2001–09										
(In millions of U.S. dollars)										
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010/1
Commitments	65.0	43.2	34.9	54.8	87.0	56.1	43.7	30.8	24.1	52.7
Disbursements	44.7	48.6	54.7	48.5	78.7	76.0	73.9	49.0	37.0	63.4
Source: Data provided by the Asian Development Bank. 1/ Planned figures.										

² Prepared by the Asian Development Bank.

ANNEX IV. LAO P.D.R.: STATISTICAL ISSUES

As of July 2, 2010

I. Assessment of Data Adequacy for Surveillance	
<p>General: Macroeconomic and financial data provided to the IMF have shortcomings that significantly hamper surveillance. Strengthening balance of payments and national accounts statistics is a priority.</p>	
<p>National Accounts: National accounts comprise annual estimates of GDP by activity at current and constant 2002 prices, broadly following the <i>System of National Accounts 1968</i>. Despite some improvements following the implementation of annual enterprise and household surveys, unresolved gaps and inappropriate data collection and compilation methodology continues to undermine the coverage and reliability of the GDP estimates.</p> <p>Price statistics: The CPI basket only includes goods and services purchased in the market, and progress on compiling a producer price index has stalled.</p>	
<p>Government finance statistics: Government finance statistics remain weak. The timeliness of fiscal reporting needs significant improvement. Off-budget activities are not included in the fiscal data, although they have expanded rapidly. Annual budget and outturn data formats do not follow international standards. Except for the annual data disseminated in the <i>Official Gazette</i>, no fiscal data are disseminated in the country.</p>	
<p>Monetary statistics: Regarding the compilation of monetary financial statistics (MFS), the sectorization, classification, and valuation of data, and the chart of accounts need to be strengthened. The Standardized Report Forms (SRFs) need to be introduced. Financial Soundness Indicators should also be compiled and published.</p>	
<p>Balance of payments: Overall, the quality of the balance of payments statistics is considered to be poor. Improvements are needed in all categories, including the current account, foreign direct investment, and private capital flows. A TA mission was proposed to the authorities to be conducted in July 2009 (the previous one was in 2002), however the BoL did not accept it stating that “the implementation of the knowledge transfer (from the 2002 mission) is not yet satisfactory, as data in this field is related to many concerned parties, and there is no completed data that can be provided yet.”</p>	
II. Data Standards and Quality	
Not a General Data Dissemination System participant.	No data ROSC is available.
III. Reporting to STA	
<p>Government finance statistics reporting for publication in the <i>International Financial Statistics</i> and the <i>Government Finance Statistics Yearbook</i>, which was initiated in early 2009, is limited to budgetary central government and has been irregular and with long delays.</p> <p>The authorities did not submit MFS data for publication in the <i>IFS</i> in 2009.</p> <p>Quarterly balance of payments data are reported once a year in a highly aggregated format. Moreover, data were not reported to STA in 2009; consequently, the last published data in the <i>International Financial Statistics</i> and <i>Balance of Payments Statistics Yearbook</i> correspond to 2007.</p>	

Lao P.D.R.: Table of Common Indicators Required for Surveillance
(As of June 25, 2010)

	Date of Latest Observation	Date Received	Frequency of Data ¹	Frequency of Reporting ¹	Frequency of Publication ¹
Exchange Rates	06/24/10	06/24/10	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ²	March 2010	05/28/10	M	I	Q
Reserve/Base Money	March 2010	05/28/10	M	I	Q
Broad Money	March 2010	05/28/10	M	I	Q
Central Bank Balance Sheet	March 2010	05/28/10	M	I	Q
Consolidated Balance Sheet of the Banking System	March 2010	05/28/10	M	I	Q
Interest Rates ³	Dec 2009	02/17/10	M	M	Q
Consumer Price Index	May 2010	06/03/10	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ⁴ —General Government ⁵	Q2 FY10	05/24/10	I	I	I
Revenue, Expenditure, Balance and Composition of Financing ⁴ —Central Government ⁵	Q4/08	05/29/09	Q	I	M
Stocks of Central Government and Central Government-Guaranteed Debt ⁶			NA	NA	NA
External Current Account Balance	Q4 2009	05/25/10	Q	I	I
Exports and Imports of Goods and Services	Q4 2009	05/25/10	Q	I	I
GDP/GNP	2009	01/26/10	A	A	A
Gross External Debt	Dec 2009	03/01/10	M	M	I
International Investment Position ⁶			NA	NA	NA

¹ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

² Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency, but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency, but settled by other means.

³ Both market-based and officially-determined, including discount rates, money market rates, and rates on treasury bills, notes and bonds.

⁴ Foreign and domestic bank, nonbank financing.

⁵ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁶ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

ANNEX V. LAO P.D.R.: MILLENNIUM DEVELOPMENT GOALS INDICATORS

		Previous	Update	Evolution
Life expectancy at birth (years)	East Asia & Pacific	70 (2004)	71 (2005)	
	Lao PDR	55 (2004)	56 (2005)	
	Low income countries	59 (2004)	59 (2005)	-
Infant mortality (per 1,000 live births)	East Asia & Pacific	29 (2004)	26 (2005)	
	Lao PDR	77 (2000)	70 (2005)	
	Low income countries	80 (2004)	75 (2005)	
Maternal mortality (per 100,000 live births)	East Asia & Pacific	117(2004)	-	-
	Lao PDR	405 (2005)	-	-
	Low income countries	684 (2004)	-	-
Child malnutrition, weight for age (% of under 5)	East Asia & Pacific	15 (2000)	15 (2005)	
	Lao PDR	40 (2000)	38 (2006)	
	Low income countries	39 (2004)	-	-
Access to improved water source (% of population)	East Asia & Pacific	79 (2004)	79 (2005)	-
	Lao PDR	51 (2004)	58 (2006)	
	Low income countries	75 (2004)	75 (2005)	-
Access to improved sanitation facilities (% of population)	East Asia & Pacific	51 (2004)	51 (2005)	-
	Lao PDR	30 (2004)	45 (2006)	
	Low income countries	38 (2004)	38 (2005)	-
Literacy (% of population age 15+)	East Asia & Pacific	91 (2004)	98 (2005)	
	Lao PDR	73 (2005)	84 (2005)	
	Low income countries	62 (2004)	74 (2005)	
Children reaching grade 5 (% of grade 1 students)	East Asia & Pacific	-	-	-
	Lao PDR	63 (2003)	68 (2008)	-
	Low income countries	72 (2003)	76 (2005)	
Primary completion rate, total (% of relevant age group)	East Asia & Pacific	98 (2004)	98 (2005)	-
	Lao PDR	74 (2004)	76 (2005)	
	Low income countries	78 (2004)	74 (2005)	

Source: World Bank data, and Population and Housing Census for 2005 (NSC).

Note: Latest year available. Maternal mortality rates for East Asia & Pacific and Low Income Countries are adjusted. Primary completion rate is the total number of students successfully completing the last year of primary school in a given year, divided by the total number of children of official graduation age in the population.



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IMF Executive Board Concludes 2010 Article IV Consultation with the Lao People's Democratic Republic

On July 28, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with the Lao People's Democratic Republic on a lapse of time basis. Under the IMF's lapse of time procedures, the Executive Board completes Article IV consultations without convening formal discussions.

Background

Lao P.D.R. weathered the global crisis well in 2009. Although the crisis did have an impact on exports, nonregional tourism, and capital inflows, GDP growth held up very well, at 7.6 percent, one of the highest in the region. Growth was buoyed by ongoing projects in the mining and hydropower sector, as well as the boost to construction and other sectors provided by a sizable fiscal expansion, an accommodative monetary policy, and one-off events such as the South-East Asia games that were held in Vientiane in December 2009.

Although inflation remains relatively contained at 4.9 percent, prices of real estate and land have been rising rapidly and an acceleration in the growth of domestic demand put pressure on

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

the external position. Gross international reserves of the Bank of Lao P.D.R. (BoL) remained relatively stable at around US\$630 million, thanks to the SDR allocation from the IMF (US\$65 million) and sales of U.S. dollar-denominated BoL securities to domestic banks (US\$43 million). However, net foreign assets (NFA) of the banking system fell by a further US\$215 million in 2009.

The pressure on the balance of payments in 2009 stemmed primarily from expansionary macroeconomic policies. The overall fiscal deficit widened by 4.4 percentage points of GDP to 7.2 percent of GDP in FY09, mainly because of a sharp increase in off-budget spending (4 percent of GDP), funded mostly by loans from the BoL to provinces to finance infrastructure projects, including for the South-East Asia Games and the celebration of the 450th anniversary of Vientiane. Monetary policy was also expansionary, with the growth of credit to the private sector rising further to 88 percent in 2009. While the bulk of the new credit continued to come from the state-owned commercial banks, credit growth by the smaller private banks was also very rapid, exceeding 100 percent in some cases. While the expansionary policies did support growth, the boost to domestic demand resulted in a widening of the nonresource current account deficit from 6 to 12 percent of GDP between 2007 and 2009. With FDI inflows slowing during this period, due to delays and postponements in mining and hydropower projects in the aftermath of the global crisis, this widening in the current account deficit resulted in the decline in banking system NFA noted above.

The outlook for GDP growth in 2010 is favorable and inflation is likely to remain moderate. Growth is projected to remain close to 8 percent, supported by a continued expansion in the mining and hydropower sectors, a rebound in nonresource exports and tourism, and continued strong domestic demand. The start of commercial operations of the Nam Theun II hydropower project in March 2010 will support growth and is expected to be an impetus for further development of the country's hydropower potential. Inflation could rise further in the next few months because of base effects but is expected to recede to 5½ percent by the end of the year.

Lao P.D.R.'s medium-term prospects are promising, provided that macroeconomic stability is maintained and structural reforms continue. The recovery of copper prices and strong demand for electricity in neighboring countries are bringing forward expansion plans in the mining and hydropower sectors, which were delayed in the wake of the global crisis. Activity outside of the mining and hydropower sectors is also projected to pick up, although this will need to be supported by continued reforms to strengthen the foundation of the economy.

The rapid expansion of the number of banks in Lao P.D.R. and the rapid growth of credit in a number of banks poses risks. Reported NPL ratios remain low, but experience in other countries has shown that NPL ratios tend to rise only during the later stages of a credit boom. Capitalization of the three state-owned commercial banks remains below the prudential limits. Collectively, commercial banks are maintaining a net long position in foreign exchange of about 2 percent of GDP and some banks are exceeding the prudential limits on the net open position. And currency mismatches in the nonbank private sector may be substantial with many borrowers in foreign currency lacking foreign currency income.

Executive Board Assessment

In concluding the 2010 Article IV consultation with Lao P.D.R., Executive Directors endorsed staff's appraisal, as follows:

Lao P.D.R.'s economy has held up remarkably well, despite the global recession. The crisis had an impact on exports, nonregional tourism and capital inflows. However, supported by ongoing projects in the mining and hydropower sector as well as expansionary fiscal and monetary policies, growth has remained higher than the average for low-income countries in Asia. At the same time, the authorities managed to contain inflation below the average for low-income countries in Asia. As a result, important gains continue to be made in improving living standards and reducing poverty. The authorities deserve credit for that.

However, expansionary macroeconomic policies put pressure on the balance of payments. Expansionary fiscal and monetary policies alongside the rapid growth of the banking system have stimulated domestic demand and imports. In conjunction with the stabilized exchange rate regime, this has put NFA of the banking system on a downward trend since mid-2008. As a result, the liquidity buffer to absorb external and internal shocks is now substantially less comfortable than during 2000–07 and the authorities should take this into consideration when assessing the adequacy of central bank reserves.

The outlook for GDP growth in 2010 is favorable and inflation is likely to remain moderate, but pressures on the external position are likely to continue. The projected narrowing of the fiscal deficit in FY2010 would make an important initial contribution to the needed policy tightening. However, on current policies, the growth of credit is expected to remain strong, boosting domestic demand and imports, and raising risks in the financial sector.

The overall fiscal deficit, which looks set to narrow by about 2 percent of GDP in FY2010, should be kept on a consolidation path over the medium term. In this regard, staff welcomes the phasing out of the off-budget spending financed by direct lending from the central bank to provincial governments. The needed medium-term fiscal consolidation should build on recent revenue gains, including from the resources sector and the newly-introduced VAT, and a prioritization of infrastructure spending.

The authorities should articulate a plan aimed at reducing the growth of credit to the private sector. The extent of the further decline in banking system NFA during 2010 will depend to a large degree on the authorities' success in reining in private sector credit growth. In light of this, all available instruments should be considered, including raising reserve requirements, stepping up sales of central bank securities to the domestic banks, raising the policy rate, and using prudential curbs.

Staff believes that the kip is overvalued, but that a stabilized exchange rate regime remains the appropriate monetary anchor for Lao P.D.R. In view of the higher risk of financial crisis and slower and more abrupt external adjustment typically associated with pegs and near-pegs, and

in light of the downward trend in NFA of the banking system, this makes it all the more important to implement consistent fiscal and monetary policies.

The rapid expansion of the number of banks and the rapid growth of credit in many banks poses high credit risks and call for extra vigilance by bank supervisors. Bank lending standards should be scrutinized and a tightening of these standards should be mandated, if deemed necessary. Existing prudential regulations should be clarified and enforced, including loan classification rules and regulations which limit banks' net open foreign currency position and prohibit bank lending in foreign currency to borrowers without foreign currency income.

Lao P.D.R.'s medium-term prospects are promising, provided that a concerted effort is made to preserve macroeconomic stability. Efforts to strengthen the soundness of the financial system should be complemented by efforts to improve the business climate and trade integration. State-owned enterprise (SOE) reforms and regulatory and legal reform required for accession to WTO membership can be expected to have important long-run payoffs.

Improvements in the quality and timeliness of statistics would improve analysis and policy making. Improvements in balance of payments and national account statistics are particularly urgent.

Staff welcomes the authorities' recent acceptance of the obligations under Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Lao P.D.R.: Selected Economic and Financial Indicators, 2005–10

	2005	2006	2007	2008	2009 Est.	2010 Proj.
GDP and prices (percentage change)						
Real GDP growth	6.8	8.6	7.8	7.8	7.6	7.7
CPI (annual average)	7.2	6.8	4.5	7.6	0.0	5.4
CPI (end year)	8.8	4.7	5.6	3.2	3.9	5.5
Public finances (in percent of GDP) 1/						
Revenue	12.1	12.5	13.9	14.4	14.9	15.5
<i>Of which: Resources 2/</i>	0.9	2.0	2.7	3.3	2.3	2.6
Grants	1.8	2.0	1.7	1.6	2.3	2.1
Expenditure	18.3	17.4	18.3	18.7	24.4	22.5
Current (includes contingency and discrepancy)	10.2	10.1	10.2	11.5	12.9	12.6
Capital and net lending 3/	8.1	7.2	8.0	7.2	11.5	9.9
Overall balance (including grants) 3/	-4.4	-2.9	-2.7	-2.8	-7.2	-4.9
Domestic financing	-0.1	-1.2	-1.1	-0.3	5.0	3.1
External financing	4.5	4.1	3.8	3.0	2.2	1.8
Money and credit (annual percent change) 4/						
Reserve money	18.2	37.2	58.8	20.2	34.7	1.2
Broad money	7.7	30.1	38.7	18.3	31.3	25.0
Bank credit to the economy 4/	7.6	-9.1	21.0	84.6	90.7	42.9
Interest rates (end-of-period)						
On three-month kip deposits	5.5	5.5	5.5	6.0	6.0	...
On short-term kip loans (one year)	17.8	14.0	11.5	11.5	10.0	...
Balance of payments						
Exports (in millions of U.S. dollars)	697	1,133	1,321	1,605	1,485	2,125
In percent change	30.1	62.6	16.6	21.5	-7.5	43.1
Imports (in millions of U.S. dollars)	1,270	1,602	2,158	2,829	2,720	3,031
In percent change	20.3	26.1	34.7	31.1	-3.9	11.5
Current account balance (in millions of U.S. dollars)	-492	-398	-672	-985	-984	-647
In percent of GDP	-18.1	-11.2	-15.9	-18.5	-17.6	-10.2
Gross official reserves (in millions of U.S. dollars)	238	336	528	636	632	555
In months of prospective goods and services imports 5/	2.2	2.5	2.8	3.3	2.8	2.0
External public debt and debt service						
External public debt						
In millions of U.S. dollars	2,203	2,351	2,521	2,949	3,109	3,270
In percent of GDP	80.8	66.0	59.7	55.5	55.5	51.6
External public debt service						
In percent of exports	7.4	3.6	4.0	4.3	5.0	4.8
Exchange rate						
Official exchange rate (kip per U.S. dollar; end-of-period) 6/	10,767	9,655	9,341	8,466	8,476	8,291
Real effective exchange rate (2000=100) 7/	99.1	104.4	104.5	114.1	120.3	122.7
Memorandum items:						
GDP at current market prices						
In billions of kip	28,948	35,981	40,467	46,215	47,567	53,727
In millions of U.S. dollars	2,726	3,564	4,226	5,313	5,598	6,341

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.

1/ Fiscal year basis (October to September).

2/ Royalties and taxes from mining and hydropower (resource) projects.

3/ Includes off-budget investment expenditures.

4/ Excludes debt write-offs. Includes Bank of Lao P.D.R. lending to state-owned enterprises and local governments.

5/ Excludes imports associated with large resource projects.

6/ Figure for 2010 is as of June 11, 2010.

7/ Figure for 2010 is as of May 2010.