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LAO PEOPLE'S DEMOCRATIC REPUBLIC

2013 ARTICLE IV CONSULTATION

December 2013

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 2013 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 2013 Article IV consultation, prepared by a staff team of the IMF, for Executive Board's consideration on November 15, 2013, following discussions that ended on September 12, 2013, with the officials of Lao on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 31, 2013.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- An **Informational Annex** prepared by the IMF.
- A **Staff Statement** of November 15, 2013, updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its November 15, 2013 consideration of the staff report that concluded the Article IV consultation with Lao People's Democratic Republic.
- A **Statement by the Executive Director** for Lao People's Democratic Republic.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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LAO PEOPLE'S DEMOCRATIC REPUBLIC

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

October 31, 2013

KEY ISSUES

Economic context. Growth was strong in 2012, and the economy is overheating from expansionary macroeconomic policies. The current account deficit has deteriorated significantly, a product of a currency appreciation in real effective terms, a growing fiscal deficit, and strong domestic demand. International reserves are inadequate for precautionary needs. Credit growth has declined, but remains excessive, raising financial stability concerns. Inflation is accelerating, and could become more broad-based.

Outlook and risks. Growth is projected at 8¼ percent in 2013 before reverting toward potential of about 7½ percent in the medium-term. Inflation is projected to remain elevated, a result of excess demand. A recent tightening of public wages should reduce the headline fiscal deficit to 4 percent of GDP in 2014, although the current account deficit is expected to remain high. FDI inflows should be vigorous, but reserve levels would remain inadequate. The economy is vulnerable to trading partners' growth and terms-of-trade shocks, and policy slippage. Banks' asset quality could also deteriorate.

Policy focus. There was broad agreement that policies should be tightened to replenish international reserves and manage a soft landing while building the foundations for broader-based growth. Restoring economic stability is a key priority.

Fiscal policy. A comprehensive medium-term budget strategy anchored around a nonmining fiscal deficit target of no more than 5 percent of GDP beginning this fiscal year would ensure debt sustainability and reduce existing vulnerabilities. Further tightening through revenue administration, public employee compensation restraint along with civil service reform, and possibly a VAT rate hike, will be needed.

Monetary, exchange rate, and financial sector policies. The USD/kip exchange rate should move more flexibly in line with market conditions with a view toward gradually building up international reserves. Domestic monetary conditions should be tightened to moderate credit growth and inflation. Financial supervision requires strengthening, with prudential measures to reduce leverage and balance sheet mismatches.

Building broader-based growth. Efforts to improve the business climate and accelerate legal compliance with the WTO will bolster trade integration and private-sector growth, enhance productivity in the nonresource sector, thereby improving economic resiliency. Public sector financial management reform will improve the quality of public spending. Upgrading health and education infrastructure will help reduce inequality.

Approved By
John Nelmes and Masato Miyazaki

Mission team: A. Ahuja (Head), G. Bannister, W. Liao, P. Ng (all APD); J. Quill (MCM); and N. Ha (Resident Representative Office). S. Kalra (Resident Representative), S. Creane, M. Seetharaman (both TAOLAM), and Q. He (STA) joined part of the mission.
Mission dates: August 28–September 12, 2013

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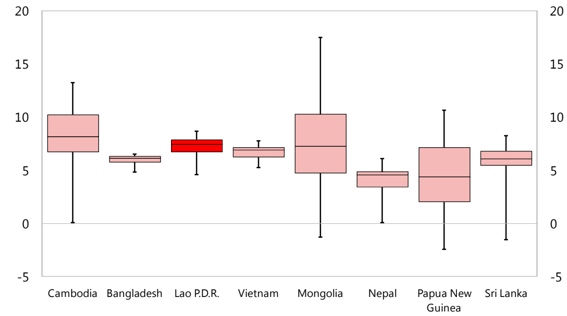
INTRODUCTION

1. A notable growth takeoff. Since the global financial crisis, the Lao economy has been growing at an average annual rate of 8 percent, supported by brisk credit expansion and robust foreign direct investment (FDI) inflows. Growth has been among the least volatile in the region over the past decade. The country has also made significant progress towards achieving the Millennium Development Goals (MDGs), and become a member of the World Trade Organization (WTO) in early 2013. The authorities are committed to achieving middle-income country status by 2020 (Vision 2020), and are targeting 8 percent annual growth over the medium term.

Volatility of GDP Growth, 2000–12 1/
(In percent)



Source: IMF's *World Economic Outlook*
1/ Each candlestick shows maximum, 3rd quartile, median, 1st quartile, and minimum growth rates, respectively, during the sample period.

2. Backdrop. In concluding the 2012 Article IV consultation, Executive Directors recommended a tightening of monetary policy to stem the risks from rapid credit growth and to replenish international reserves. Moreover, they urged restraint in civil service compensation increases to protect the fiscal buffers to deal with future shocks. Since then, the economy has been overheating from expansionary macroeconomic policies. The fiscal budget has come under stress, credit growth remains excessive, international reserves have declined further and are inadequate for precautionary needs, and signs of foreign currency shortage have emerged. Against this backdrop, the 2013 Article IV consultation focused on policies to return the economy toward macroeconomic and financial stability while building the foundations for broader-based growth.

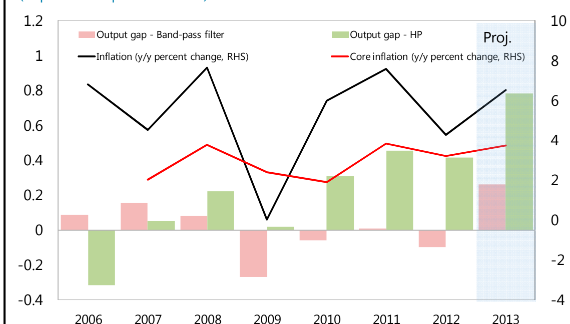
PRESSING CHALLENGES, OUTLOOK, AND RISKS

3. An overheating economy. Spurred by the fiscal expansion and rapid credit growth, the economy is growing beyond short-term capacity constraints. Real GDP expanded by 8 percent in 2012, buoyed by investment and private consumption. Investment in hydropower, infrastructure, and real estate—some related to the 2012 Asia-Europe Meeting—significantly lifted construction activities and imports. Strong expansion in the services sector and nonresource imports reflected robust domestic consumption and tourism activity. Growth is projected to rise to 8¼ percent in 2013 and moderate to 7½ percent in 2014 on account of a less expansionary fiscal stance. Staff's medium-term baseline projection (Table 5) is predicated on the authorities' announced policy intentions, which are weaker than staff's recommendations, particularly with regard to a re-loosening of public employee compensation. It also depends on vigorous resource-related FDI inflows, growing electricity demand from neighboring countries, a gradual pickup of investment inflows into nonresource sectors following recent WTO accession, and progress on tax system and administration reforms.

4. **A vulnerable external position.** The current account deficit surged from 15½ percent of GDP in 2011 to 28½ percent of GDP in 2012, a product of strong domestic demand, a growing fiscal deficit, a moderate terms-of-trade deterioration, and a sharp currency appreciation in real effective terms. International reserves decline further to 0.8 month of prospective imports (June 2013), and remain inadequate for precautionary needs (Box 1). While FDI remained strong in 2012, covering approximately 54 percent of the current account deficit, the portion of the current account not financed by FDI or official development assistance—the core balance of payments—is estimated to be in deficit at 10½ percent of GDP. These developments confirm staff's model-based assessment of a growing real exchange rate overvaluation relative to medium-term fundamentals. Looking ahead, the current account deficit is expected to remain close to 30 percent of GDP in 2013–14 before large-scale power projects come on stream in 2015–16 and lift medium-term exports. Although FDI inflows are expected to be vigorous over the next two years, reserve levels would be inadequate by low-income country (LIC) metrics at less than 1½ months of imports.

5. **Rising price pressures.** After easing considerably in 2012, headline inflation accelerated to 6.9 percent (y/y) in September 2013, mostly a result of fresh food prices. The appreciation in the nominal effective exchange rate and sluggish adjustment in the prices of publicly provided goods and services have kept core inflation in check. Nevertheless, core inflation has picked up momentum during the past few months. As economic activity expands beyond potential, consumer price inflation is projected to reach 7½ percent by end-2013 and average at that level in 2014.

Output Gap and Inflation 1/
(In percent of potential GDP)



Sources: Country authorities; and IMF staff estimates.
1/ Latest core inflation as of September 2013.

6. **Strained public finances.** Instead of consolidating as expected in last year's report, the fiscal position deteriorated in FY2011/12–FY2012/13, with the overall deficit estimated at 6½ percent of GDP and a nonmining deficit of 8¾ percent of GDP in FY2012/13. Government liquidity is tight, with deposits covering around 1 month of current spending (June 2013), down from 3¼ months at the end of the previous fiscal year. Wage and other arrears of about 2–3 percent of GDP are emerging with knock-on effects on private contractors' ability to pay suppliers and service debt. This is the result of: (i) a 37 percent increase in public sector salaries and an additional 140 percent increase in benefits; (ii) higher capital spending, some of which is off-budget and financed by the Bank of the Lao P.D.R. (BOL); and (iii) lower revenue from the natural resource sector from declining copper and

Lao P.D.R.: Main Fiscal Aggregates
(percent of GDP)

	2011/12	2012/13	2013/14		
		Proj.	Prelim. Budget	Revised Budget	Proj.
Revenue	19.6	19.6	22.2	22.2	20.6
Expenditure 1/	24.4	26.1	25.7	23.6	24.5
Compensation of employees	5.0	10.0	11.8	9.7	9.7
Capital spending	9.2	8.9	6.8	6.8	6.8
Other 1/	10.2	7.2	7.1	7.2	7.2
Net lending/borrowing 1/	-4.8	-6.5	-3.6	-1.5	-3.8

1/ Including discrepancy from financing below the line in 2011/12.

Box 1. Lao P.D.R.: External Sector Assessment

Exchange Rate Assessment

	Macrobalance	External Sustainability
Approach:		
Underlying current account balance	-15.1	-17.0
Current account norm	-9.0	-13.0
Required improvement in the current account	-6.2	-4.0
Implied over (+) / under (-) valuation	24.3	15.8

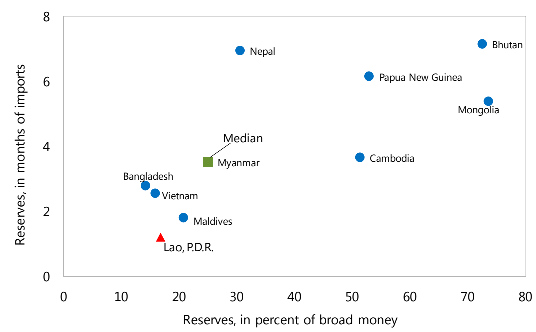
Source: IMF staff estimates.

External competitiveness has further eroded. Overall labor costs have risen by approximately 25 percent per year during 2009–2012. The Kip real effective exchange rate (REER) has appreciated by about 7 percent during the past 12 months (July 2013), roughly half of this is due to higher domestic inflation. Analysis based on the current account approach indicate that the underlying current account deficit is significantly higher than the norm estimated using cross-country panel regressions with a 24 percent real depreciation (in effective terms) necessary to bring the deficit down to the current account norm, *ceteris paribus*. Similarly, the external sustainability approach finds that a 16 percent real depreciation would be needed to stabilize net foreign asset (NFA) at the levels estimated in 2012. Targeting a healthier NFA position of -80 percent of GDP would imply a degree of overvaluation of 30 percent.

In contrast to the current account approach, the equilibrium exchange rate approach indicates no misalignment of the kip. These results are well within the margin of error, which can be large because of data limitations. In staff's view, the broader trends in the current account balance suggest a growing overvaluation.

Reserves: South and East Asian LICs

End 2012



Sources: Country authorities; IMF WEO.

Capital account inflows have strengthened in 2012, particularly public sector inflows and FDI, the vast majority of which continues to finance hydropower projects. Moreover, private inflows appear to have picked up.

Despite steady capital inflows, at current levels, international reserves do not offer adequate protection against adverse external shocks. As of June 2013, international reserves cover only 0.8 months of prospective imports and 10 percent of broad money. These reserve coverage levels are the lowest among Asian LICs, and significantly below the traditional metrics of at least three months of prospective imports or up to 50 percent of broad money, respectively. The optimal reserves level is estimated to be close to 4 months of imports.[1] However, given the high degree of dollarization in the Lao economy, this optimal reserves coverage should be interpreted as a lower bound, as currency substitution would add to the need for international reserves coverage.

Lao P.D.R.: Measures of International Reserves Coverage

	2000–08 Average	2009	2010	2011	2012	2013 Latest
Gross International Reserves						
In millions of U.S. dollars	295.3	632.9	728.3	677.4	739.6	532.0
In months of prospective imports	2.2	2.0	1.8	1.2	1.2	0.8
In months of prospective imports, excluding resource imports	2.8	2.5	2.6	1.7	1.7	1.2
In percent of foreign currency deposits	81.3	76.8	63.9	45.4	39.0	25.5
In percent of broad money	50.8	35.4	28.1	19.9	16.5	9.9
In percent of external debt service	551.4	670.4	611.4	671.8	452.3	224.0

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

Staff's overall assessment is that the external position is vulnerable to shocks, and would benefit from further strengthening through fiscal consolidation, the tightening of domestic monetary conditions, and structural reforms to improve productivity over time, particularly in the nonresource sectors.

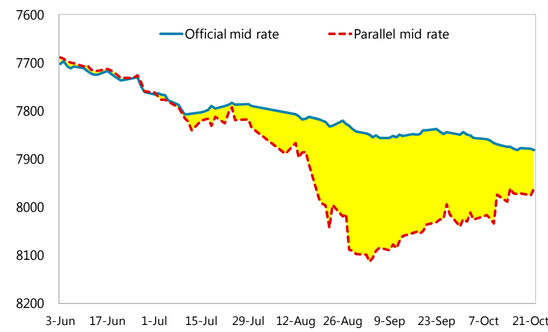
1. See the IMF Working Paper *Optimal Precautionary Reserves for Low-Income Countries: A Cost-Benefit Analysis* (WP/11/249) and IMF Board Paper *Assessing Reserve Adequacy* (February 14, 2011).

gold prices. As a result of the wage increase, public sector wage bill has risen to 50 percent of revenue, and is now well above LIC average (Box 2). With the suspension of additional benefits payment to public sector employees and the reduction in capital spending announced in September 2013, the headline deficit is projected to decline to around 4 percent of GDP in 2014 (nonmining deficit of 6½ percent of GDP). The headline deficit is expected to rise to around 5½ percent of GDP in 2015 (FY2014/15) on account of further increases in public sector salaries, before declining gradually to 3½ percent of GDP over the medium term. Public sector debt, which remains elevated compared with regional LICs, has risen sharply, and is expected to peak at 64 percent during 2014–16. Staff expects additional bond issuance in Thailand following the US$50 million issuance this year, which was oversubscribed.

7. Loose financial conditions. Credit growth remains vigorous at 35 percent (y/y) (June 2013). Kip liquidity in the banking system remains ample, giving banks scope to expand credit supply. Though banks' direct exposure to real estate is limited, urban land prices, reportedly up by 30 percent during the past few years, have boosted credit demand and encouraged some banks to ease lending standards. Deposit growth is rapid at 28 percent (y/y) in June 2013 while short-term (3 months) deposit interest rates are negative in real terms. Overall banks' excess reserves at the BOL are high at 11 percent of total deposits (June 2013), though signs of foreign currency liquidity shortage in the banking system have emerged. Reflecting this shortage, the parallel foreign exchange market has been trading at a premium over the BOL's reference exchange rates since mid-August. Foreign currency lending capacity will become more constrained, as banks' claims on the economy have exceeded 90 percent of deposits.

Exchange Rates

(Kip/USD)

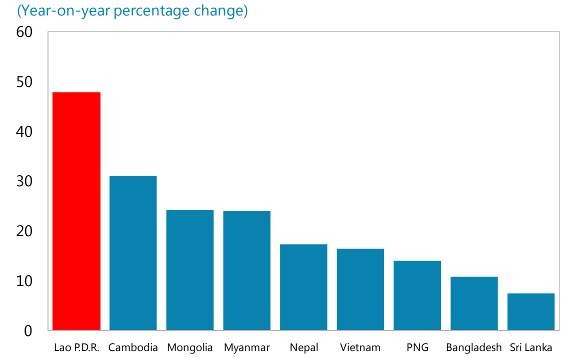


Source: Lao P.D.R. authorities

8. Financial stability concerns. Bank credit has expanded rapidly since 2008, considerably faster than in other Asian LICs (Box 3). Financial soundness indicators available are not up-to-date. Supervisory capacity and risk management practices at banks may not be robust enough to ensure high lending standards, raising concerns about domestic banking sector soundness. Furthermore, the capital of two state-owned commercial banks is well below the regulatory minimum, potentially a fiscal risk.

Annual Average Real Credit Growth, 2007–12

(Year-on-year percentage change)



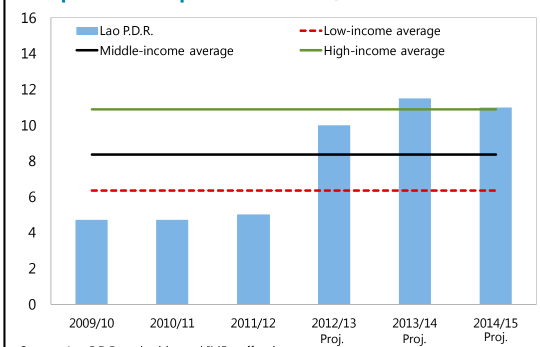
Sources: Country authorities; and IMF staff estimates.

Box 2. Lao P.D.R.: Increase in Civil Service Compensation[1]

A large increase in salaries and benefits for public employees was implemented in 2013, as part of the stated plan to increase the compensation of public employees over three years:

- The civil service salary index rose by 37 percent in 2013 and is expected to rise by the same percent each year in 2014 and 2015.
- Benefits (salary supplements) rose by 140 percent in 2013; this increase was reversed in 2014, bringing benefits back to the level of 2012. For 2015 they are assumed to rise with inflation.

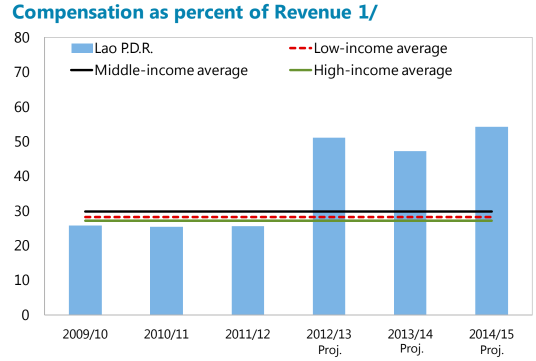
Compensation as percent of GDP 1/



Sources: Lao P.D.R. authorities and IMF staff estimates.
1/ Average in 2010

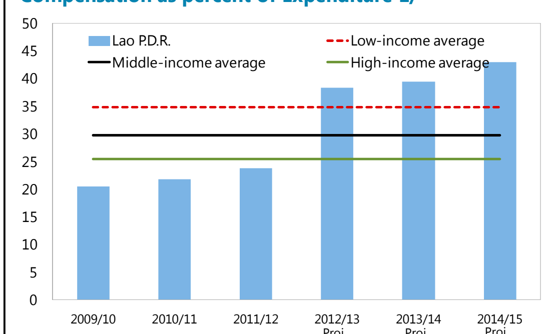
Evidence for the increase is mixed. The increase has been justified to attract workers with the required skills and to discourage turning to outside employment to supplement incomes. A World Bank study, published in 2010, found that compensation from the formal salary for civil service workers was well below private sector comparators. However, when the calculation took into account intangible benefits, such as fewer hours worked and lower work demands, more stable employment and earnings, in-kind benefits, housing and education allowances, and opportunities to supplement incomes through per-diems, the private sector premium disappeared.

Compensation as percent of Revenue 1/



Sources: Lao P.D.R. authorities and IMF staff estimates.
1/ Average in 2010

Compensation as percent of Expenditure 1/



Sources: Lao P.D.R. authorities and IMF staff estimates.
1/ Average in 2010

Nevertheless, the study also documented a strong perception among civil servants that their remuneration was not sufficient to cover even basic expenses.[2]

The increase brings civil service compensation well above the average level for international comparators. Public compensation doubled from 5 percent of GDP in 2012 to 10 percent of GDP in 2013, well above the level of 6.3 percent for LICs.[3] In terms of revenue, compensation rose over the same period from 25 percent to 50 percent, well above the low-income average of 28 percent. Finally, in terms of expenditure, compensation rose from 24 to 38 percent, above the low-income average of 35 percent.

1. All figures are on a fiscal year basis.

2. "Lao P.D.R. Civil Service Pay and Compensation Review: Attracting and Motivating Civil Servants". World Bank, June 2010.

3. International comparator averages are from 2006 to 2010, calculated from the FAD employment and wages database.

Box 3. Lao P.D.R.: Normal Financial Deepening or Excessive Credit Growth?

Financial fragility is generally built up over an extended period. Episodes of sustained, rapid credit growth can take place in a period of low inflation but accompanied by sharp rises in asset prices. They tend to end abruptly, with a possibility of a financial crisis, and can be difficult to identify ahead of time. To add to the complication, policymakers in LICs do not have access to reliable asset price statistics. This box provides a simple, robust indicator, constructed using only information available to the policymakers in real time, that can help identify an excessive credit growth episode with enough lead time to analyze and act.[1]

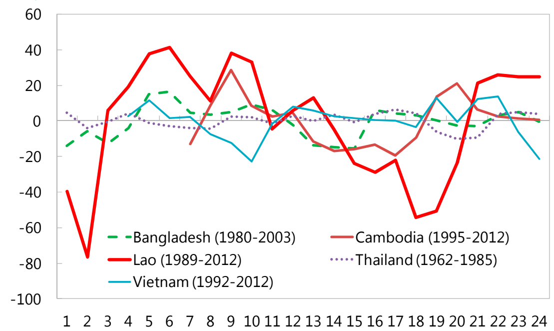
Performance of the Early Warning Indicator

Horizon	Noise/Signal	Number of Crisis predicted	% predicted
1 year	0.45	24	56
2 year	0.35	30	70
3 year	0.31	34	79

Source: Staff estimates.

Identifying a credit boom in the making. Benign credit growth episodes can be distinguished from those that could undermine financial stability by observing the deviation in percentage points of credit-to-GDP from trend. This credit gap measure signals a valid warning, producing a low noise-to-signal ratio. Specifically, the credit gap threshold of 4 percentage points enables us to predict past financial crises correctly within three years with close to 80 percent probability, including 5 out of 9 banking crisis episodes in LICs.

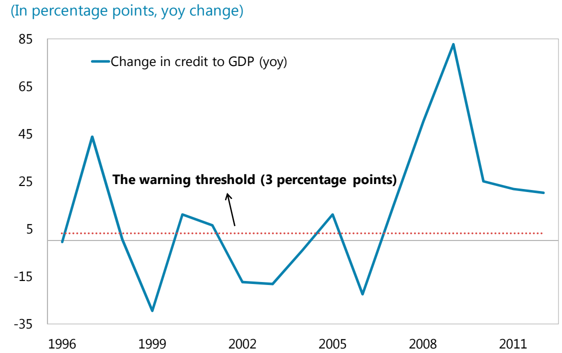
Selected Asian Countries - Private Credit Gap
(In percent of GDP)



Sources: Authorities; and IMF staff calculations.

Is Lao P.D.R.'s credit growth excessive? The credit gap measure suggests that credit growth has been excessive during the past few years, providing an early warning of possible distress down the road. It also exceeded most regional comparators in their initial financial deepening stages, including Vietnam, Bangladesh, Cambodia, and Thailand. Moreover, credit-to-GDP ratio has been growing beyond the warning threshold of 3 percentage points over a period of time (GFSR, September 2011)

Credit to GDP Ratio
(In percentage points, yoy change)



Source: Lao P.D.R. authorities

Other useful indicators. The period before crisis episodes is typically associated with large capital inflows, expansionary macroeconomic policy stances, lack of macro-prudential attention, higher-than-normal current account deficits, and buoyant domestic demand. A loose fiscal stance and lack of macro-prudential control have been identified as significant contributors to the probability of future financial distress. These indicators currently suggest that credit overheating in Lao P.D.R merits close monitoring.

1. See Ahuja, A. and W. Liao, 2013, "Assessing Credit Boom: The Case of Lao P.D.R," forthcoming IMF working paper.

9. External debt sustainability. Because of the high level of concessionality of official external borrowing and favorable long-term GDP growth outlook, the risk of external public debt distress remains moderate (see the Debt Sustainability Analysis). Nevertheless, compared to last year's assessment, the external public and publicly guaranteed (PPG) debt level is closer to its safety threshold, which leaves few buffers in the near term in case of an adverse shock. Staff's analysis also shows that the external PPG debt-to-GDP ratio could be pushed beyond sustainable levels under certain stress scenarios, including sharp currency devaluation, less favorable FDI inflows, a significant deterioration in domestic and external environment, and higher borrowing costs which may be associated with new infrastructure mega-projects.

10. Risks to growth and stability. Although trade and investment reforms could be accelerated to take full advantage of recent WTO membership, thereby increasing foreign-funded nonresource investment and growth relative to the baseline, on balance, risks to the outlook are skewed toward the downside (see the Risk Assessment Matrix). The external position is vulnerable to a slowdown in trading partners' growth and terms-of-trade shocks. Moreover, the heightened vulnerabilities have subjected the outlook to considerable uncertainty. Policy slippage beyond an already weak baseline scenario could raise near-term pressures on the balance of payments and inflation, and further deplete international reserves. This would bring into question the sustainability of the exchange rate anchor, domestic banking sector soundness, and undermine the prospects for high-quality growth and attaining middle-income status by 2020.

- **External spillovers.** A deeper-than-expected slowdown in China, Thailand, and Vietnam could weaken nonresource exports and foreign investment flows to Lao P.D.R. A sharp slowdown in China, in particular, could depress world mineral prices and neighbors' electricity demand, putting further pressure on Lao P.D.R.'s fiscal revenue, export earnings, international reserves, and the exchange rate, raising concerns over external debt sustainability.
- **Financial sector risks.** A deterioration of banks' asset quality would erode capital, which could become future contingent liabilities for the state. In the most adverse scenario—assessed to be of medium likelihood—a loss of confidence in the domestic banking system could be precipitated by a large loss of international reserves and sudden currency devaluation. The initial impact would be limited for dollarized economic entities, but the degrees of currency mismatch in the balance sheets of the economic sectors remain unknown. Given the elevated external debt position and considerable foreign currency lending, credit risks would increase. The impact on business, bank, and household balance sheets would be difficult to endure, also putting into doubt the sustainability of public debt.
- **Fiscal risks.** The pressure to meet social spending targets or respond to natural disasters in the presence of higher public sector wage bills could weaken the fiscal position more than already expected. This could worsen the public debt dynamics, and give rise to larger off-budget capital spending and more contingent liabilities down the road. The pressure for financing could further undermine the BOL's monetary control.

11. Authorities' view. There was broad agreement that the medium-term outlook for Lao P.D.R. remains generally favorable, but the growing vulnerabilities, including low international reserves cover, have significantly raised the uncertainty around the near-term outlook. The authorities noted that international reserves coverage remains around 2½ months of officially reported nonresource imports, which are significantly lower than trading partners' export data that staff uses. While the authorities share concerns about regional spillovers, terms-of-trade, and fiscal risks, they emphasized the ongoing efforts to contain financial sector risks, pointing to the slowly declining credit growth and efforts to ensure that lending is channeled toward productive use. The authorities would continue to monitor financial market conditions closely for signs of distress. Moreover, they expressed confidence that international reserves would rise toward the end of 2013 from scheduled foreign banks' registered capital increase and domestic foreign currency debt repayment to the BOL.

ENGINEERING A SOFT LANDING

12. Key policy recommendations. The tightening of fiscal and monetary policies is an urgent priority for reducing external and financial sector vulnerabilities, replenishing international reserves, and restoring macroeconomic stability to ensure high and sustainable medium-term growth. Success will require an acceptance that the short-term growth outcome could be lower than the 8 percent annual target. Fiscal policy needs to be put back on a consolidation path during the next few years. This will require improving tax collection by broadening the tax base, eliminating exemptions, and possibly a VAT tax rate increase, while rationalizing expenditure to concentrate on priority social spending and investments and postpone further civil service pay increases. Given the extent of the estimated real effective exchange rate overvaluation and loss of external competitiveness, the kip nominal exchange rate should be allowed to move in line with market conditions with a view toward enhancing competitiveness and gradually building up international reserves. The credit and M2 growth targets should be lowered to contain inflation. Financial sector supervision will need to be strengthened and regulatory measures put in place to reduce leverage and balance sheet mismatches. If implemented, this mutually supporting policy package would result in lower near-term growth than staff's baseline projection, but it would also reduce current vulnerabilities and enhance macroeconomic and financial sector resiliency, supporting robust, sustainable medium-term growth.

13. Authorities' view. The authorities attached great importance to achieving Vision 2020, and were receptive to staff's call for policy tightening. They indicated that the bulk of near-term adjustments would be borne by fiscal policy, and have undertaken action to boost revenue as well as limit capital spending and civil service compensation increase. There is room for the USD/kip exchange rate to move within the current band, in line with market conditions and external developments. The credit and broad money growth targets would be lowered as public investment demand softens going forward.

A. Fiscal Policy

14. Deficit targets. Fiscal consolidation is essential to reduce excess demand, credit growth, and the current account deficit. It will also enable capital to be put to more efficient use, which in turn will enhance the resiliency of the financial system. Staff recommends a medium-term budget strategy that is anchored around a nonmining fiscal deficit target of no more than 5 percent of GDP starting in FY2013/14 to reduce public debt to 40 percent of GDP by 2020. In the process, the saving of mining revenue will help ensure a smooth expenditure path and a comfortable level of government deposits. The authorities' announced plans are, however, less ambitious—the nonmining deficit would fall from 6½ percent of GDP in FY2013/14 below 5 percent of GDP only by FY2017/18 under staff's baseline projection.

15. Expenditures. Staff recognizes the need for an increase in civil service pay to compensate for cost-of-living increases, enhance competitiveness with the private sector, especially in health and education, and to combat graft. But containing overheating pressures and ensuring fiscal sustainability will require a more measured pace of future compensation increases. Moreover, there is an urgent need for progress on civil service reform and for rationalizing other spending to reduce the burden on the budget. In addition to controlling nonwage current expenditures, the government should also trim capital spending in FY2013/14 to the average level of the previous two years (equivalent to 7 percent of 2014 GDP) and draw up a plan to eliminate arrears. This would also be more in line with implementation capacity, reduce off-budget financing, and enhance monetary discipline. Public sector financial management reforms are needed to enhance control over spending and efficiency at all levels of government.

16. Revenues. Meeting the authorities' deficit target over the next few years would require raising revenue (excluding grants) from about 18 percent of GDP to at least 19½ percent of GDP by 2015. This will require an additional tax effort of 1–1½ percent of GDP, which can be achieved by moving decisively on ongoing reforms of the tax system and administration. Specifically, these will require efforts to simplify the tax system and enhance compliance, including a simplification to the VAT system, profit tax rate unification across firms, the introduction of a lump-sum tax for small businesses, as well as taxes on property value, and increases in petrol and vehicle excise duties. Building on recent IMF TA recommendations, the government should also reform customs and natural resources revenue administration, and the management of large taxpayers. To achieve staff's recommended fiscal consolidation, however, a VAT rate increase (from the current 10 percent) may also be needed starting in the emerging fiscal year.

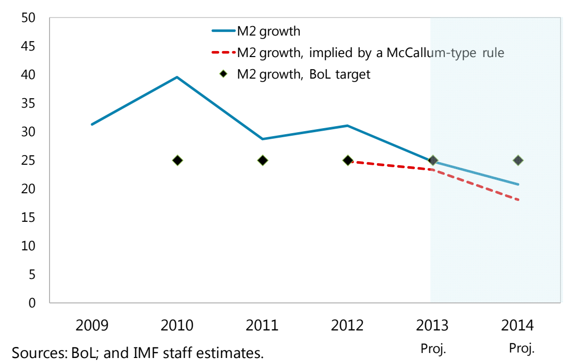
17. Authorities' view. The authorities acknowledged that the fiscal expansion from public sector pay increases in FY2012/13 was sharper than they originally expected and posed serious risks to macroeconomic stability. While the near-term focus would be on addressing liquidity challenges, the government also recognized the need to formulate a comprehensive medium-term budget strategy and impose stricter expenditure control. Action has been taken to contain domestically financed current and capital spending, broaden the tax base, limit tax exemptions for new investment contracts as well as for imports of vehicles and fuel, reduce off-budget spending, and pay down wage arrears. The authorities also recognized that revenue mobilization would have to go hand in hand with technology and staff capacity, which would take time to improve. With these measures in place, they believed that the headline fiscal deficit would not exceed 5 percent of GDP on average over the medium term.

B. Monetary and Exchange Rate Policy

18. Exchange rate management. Staff continues to support the use of the USD/Kip exchange rate anchor within a band, which is reasonably wide and adjustable annually. However, to maintain this nominal anchor, especially during a turbulent period when the US Federal Reserve is expected to exit from unconventional monetary policy, the BOL will need to: (i) make full use of exchange rate flexibility in line with market conditions with a view toward building a considerably larger international reserves cushion; and (ii) tighten domestic monetary conditions. These measures will lessen the need for tighter administrative measures, such as limits on commercial bank supply of foreign exchange, which could undermine the confidence in the kip and fuel one-way depreciation expectations, potentially reversing de-dollarization gains (Box 4).

19. Monetary policy. Given that output is already above potential, inflation forecast remains elevated, and credit growth appears excessive, domestic monetary conditions should be tightened. To absorb excess liquidity in the banking system, the BOL should: (i) issue a sufficient amount of securities; (ii) increase the reserve requirement ratio on kip deposits, which could be done in small increments with guidance ahead of time; and (iii) accelerate the unwinding of quasi-fiscal lending operations to local government entities and SOEs. It will be important to ensure access to bank reserves (including foreign currency) through BOL facilities and interbank borrowing to avoid financial market disruption. In tandem, the BOL should raise interest rates at its lending facilities. Over the medium term, interest rates should play a central role in monetary policy conduct. Toward that end, staff encourages the BOL to make use of technical assistance to help strengthen the monetary policy framework, liquidity forecasting and liquidity management, and interbank market development.

Broad Money
(Year-on-year percent change)



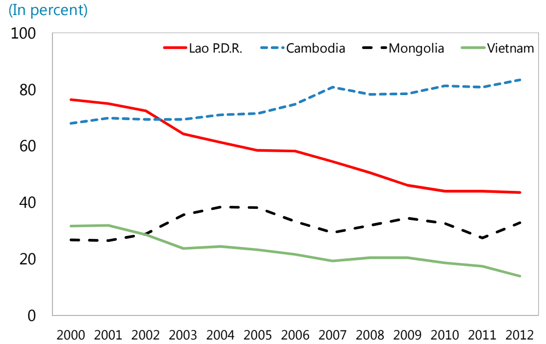
Sources: BoL; and IMF staff estimates.

20. Authorities' view. The BOL agreed with the need to allow the exchange rate to adjust flexibly within the current band to preserve international reserves. In their view, as international reserves are expected to increase by end-year, the current foreign currency liquidity shortage should be temporary, and the resulting parallel market premium is unrepresentative of market expectations. With the government already committed to stop borrowing for new development projects and eschew from central bank deficit financing, monetary discipline will be enhanced and credit expansion should be weaker in 2014.

Box 4. De-dollarizing the Lao P.D.R. Economy

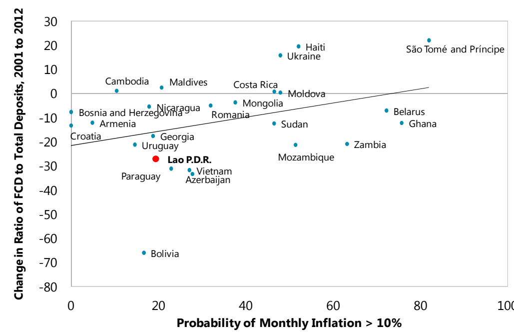
Substantial progress made. Over the past decade, Lao P.D.R has made substantial gains in de-dollarization. The dollarization rate, as measured by foreign currency deposits as a ratio of broad money, declined from 76% in 2000 to 43% in 2012, far outperforming regional comparator countries. The decline in the dollarization rate is consistent with a significant improvement in macroeconomic stability. In particular, inflation has fallen markedly, from a peak of 128% in 1999, to an average of around 5% in 2005–12. Confidence in the Kip has increased, as suggested by the uptrend in both the NEER and the REER over the past five years. The authorities have also actively taken measures to promote Kip usage.

Foreign Currency Deposits to Broad Money
(In percent)



Sources: Country authorities

Degree of Dollarization vs Probability of High Inflation



Sources: Country authorities; and IMF, *WEO*

Further de-dollarization requires sustained macroeconomic stability. International experience shows that reversing dollarization is a protracted process, requiring sustained prudent macroeconomic policies. Countries such as Israel and Poland that have been identified in the literature as having successfully de-dollarized with minimal side effects and capital flight have implemented and persisted in economic stabilization programs. Conversely, countries that exhibited repeated bouts of high inflation over the past decade generally have been less successful in reducing dollarization rates.

Risks associated with dollarization. A partially dollarized financial system carries with it specific risks. First, banks will not be able to accommodate persistent withdrawals of foreign currency deposits, given limited holdings of liquid foreign assets, and the central bank's ability to act as a lender of last resort in these events is constrained. Second, vulnerabilities may result from currency mismatches in banks' balance sheets, as borrowers' currency mismatches could expose banks to foreign currency-induced credit risk.

Risk mitigation. To mitigate these risks, robust banking sector supervision and higher international reserves are required. In addition to measures that limit currency mismatches on bank balance sheets and moving towards risk-based supervision, the central bank should have sufficient foreign exchange reserves to forestall a run on foreign currency deposits.

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1. See IMF Occasional Paper by Balino, Tomas, Adam Bennett, and Eduardo Borenszten, *Monetary Policy in Dollarized Economies* (1999).

C. Bank Supervision and Prudential Policies

21. Achievements and challenges. The entry of new foreign and private banks in recent years has brought in technical skills, expanded access to banking services, and helped create a more commercially oriented banking sector. The depth of the financial system has increased significantly, but financial access by small and medium enterprises remains limited. The existing body of the law is reasonably constructed to provide for appropriate supervisory authorities and sound commercial bank requirements. External auditing requirements have been introduced, and a depositor protection system established. That said, much work remains to build a resilient financial sector. Given that financial activities are driven largely by the government's development objectives, there are concerns that supervision and regulatory enforcement and bank risk management practices could be compromised. Furthermore, weaknesses remain in the regulatory framework, in particular the lack of a clear and uniformly applied accounting framework and an effective and prompt debt resolution process.

22. Strengthening financial supervision. Staff reiterates the need to ensure that the pace of financial deepening is in line with progress in regulatory and supervisory capacity. At this stage, a more rigorous application and enforcement of laws and regulations is needed to ensure consistent compliance. To reduce balance sheet vulnerabilities, staff supports the BOL's strict monitoring of banks' compliance with the regulation on net open foreign exchange positions, as well as enforcing the limits on foreign currency lending to borrowers without sufficient foreign currency income. Furthermore, the BOL's requirement for banks to publish their balance sheets online should be enforced, and financial soundness indicators should be updated and complete. In addition to the required increase in commercial banks' registered capital, which will be completed in 2014, riskier banks should be required to maintain higher capital-to-asset (CAR) ratios than the minimum mandated CAR of 8 percent. This measure would also contribute to leverage control. More urgently, under-capitalized banks should not continue to increase their loan portfolios, and potentially incur additional risk. In this light, a prompt corrective action framework should be developed. It will also be critical to develop a forward looking, risk-based approach to supervision to identify and mitigate emerging risks at an early stage. Staff also urges the BOL to prepare a contingency plan for the banking sector in the event of financial distress, and enhance the size and operational readiness of the Depositor Protection Fund. Staff welcomes the authorities' commitment to move forward on the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) Law to address deficiencies identified by the Financial Action Task Force during the upcoming fiscal year, and continues to encourage their participation in an FSAP.

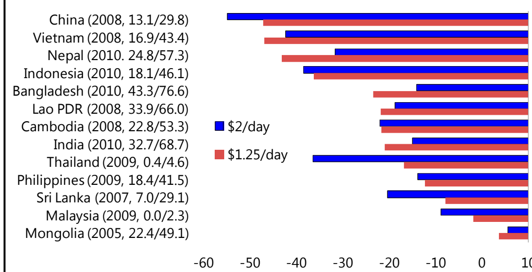
23. Authorities' view. The authorities agreed with staff's overall assessment and recommendations, although the plan to require riskier banks to maintain higher CAR than the regulatory minimum would need to be considered carefully. They noted that internal CAMEL-based financial soundness indicators point to a generally sound banking system. Furthermore, the BOL has already started to tackle some of the supervisory weaknesses raised by staff, including strengthening the loan origination process based on income flow projection as well as collateral, and will receive

IMF TA on banking supervision in 2013Q4. Over time, as the financial system becomes more complex, the BOL plans to build the framework and capacity for risk-based supervision.

BUILDING SUSTAINABLE AND INCLUSIVE GROWTH

24. Key issues. Lao P.D.R. continues to make impressive progress in growing its economy and poverty reduction. However, the World Bank Doing Business Survey (2013) indicates limited progress in public service delivery and facilitation of private sector-led growth. Moreover, inequality has increased significantly during the past two decades and could raise social and ethnic tensions (Box 5).

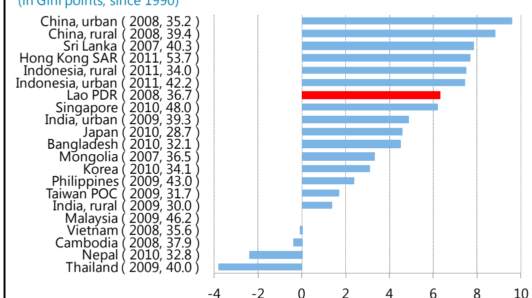
Asia: Change in Poverty Headcount, Last Two Decades[1]
(in percentage points since 1990)



Sources: World Bank; and IMF staff calculations.
[1] At 2005 PPP prices. In parentheses, the latest available year and corresponding poverty headcount ratios at $1.25 and $2 per day, respectively.

25. Structural policies. To sustain the growth takeoff and improve its inclusiveness, efforts are needed to improve the business climate, enhance information exchanges and coordination among government agencies, and undertake public sector financial management reforms to upgrade the quality of public spending. Public spending should be prioritized toward health, education and skills training, as well as basic infrastructure. Further trade liberalization should promote institutional reform and economic competition, offering potential to make growth more productivity-driven and broader-based. Productivity enhancement in the nonresource sector would in turn improve the trade balance and strengthen the international reserves cover, which will help reinforce economic resiliency.

Asia: Change in Gini Index, Last Two Decades[1]
(in Gini points, since 1990)



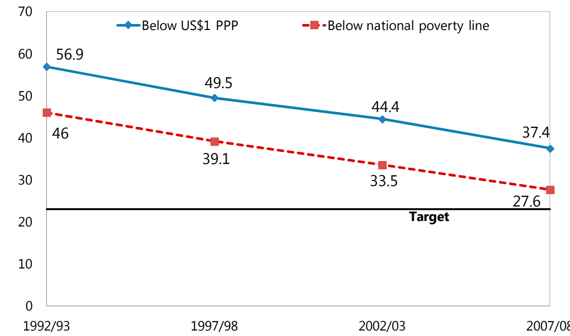
Sources: World Bank; national authorities and IMF staff calculations.
[1] In parentheses, the latest available year and corresponding Gini coefficients.

26. A statistical strategy for growth. Modernizing and upgrading the quality and comprehensiveness of economic and financial sector data is a key priority. Data weaknesses have obstructed monitoring and analysis of risks, and led to shortcomings in policy formulation and policy evaluation. Staff welcomes the government's commitment to implement the Strategies for the Development of the National Statistical System, and the intention to collaborate with the IMF in moving Lao's macroeconomic statistics closer to the international standards, including using the General Data Dissemination System (GDDS) in compiling and disseminating data.

27. Authorities' view. The authorities are undertaking significant revisions to trade-related laws and regulatory regime in anticipation of the opportunities for further trade integration under the WTO and ASEAN Free Trade Agreement. Over time, private investment is expected to be the key

Box 5. Lao P.D.R.: Poverty and Inequality: Trends, Determinants and Policies[1]

Poverty ratios
(in percent)



Source: Lao Expenditure & Consumption Surveys (LECS 1-4), Lao Statistics Bureau, MPI.

Profile and trends. National poverty rate declined from 46 percent in 1992/93 to 28 percent in 2007/08 (latest available estimate). There has also been a steady reduction in the poverty gap and severity over this time, implying that the drop in poverty benefitted the neediest. While progress in poverty reduction has lagged somewhat behind China, Vietnam, and Indonesia, Lao P.D.R. is on track to achieving the MDG target of halving the poverty rate by 2015. Poverty rates have declined across nearly all population groups, including rural, mountainous and upland areas which show the highest poverty incidence due to difficulties in access to markets. Even though the Gini coefficient is still low compared to regional emerging markets, inequality has increased substantially since 1990.

Determinants. Overall, rapid economic growth has benefited the poor. Major drivers of poverty reduction include liberalization of the private sector, which increased access to markets for trade and employment, increasing access to electricity, and expansion of the road network. Increased integration with regional neighbors benefited a significant part of the population, especially those along the regions bordering Thailand, China, Myanmar and Cambodia. Rural poverty reduction lags behind largely due to fewer livelihood options, and pockets of urban poverty are emerging. The benefits of growth have been especially limited to those in geographically disadvantaged areas.

Policy focus. The Seventh National Socio-Economic Development Plan (2011–2015) has a strong focus on sustainable economic growth and poverty reduction, and the government is making efforts to tackle disparities. Strategies include providing basic infrastructure and services in remote areas, improving skills of local populations, providing incentives to government workers serving in remote areas, promoting measures to improve food security and nutrition in the uplands, supporting Farmer Organizations, and increasing the commercialization of the agriculture sector. The government is also taking special measures to address concerns about the threat facing rural livelihoods as agricultural lands are converted into land used for FDI projects. For example, the government has established special revenue-sharing arrangements for the Nam Theun II Hydroelectric Project (funds for health, education, rural infrastructure and environment) and direct intervention schemes (e.g., funds for village poverty eradication and small entrepreneurs in the poorest districts).

Challenges. At the national level, reform of education and training systems are necessary to develop well-functioning labor markets that meet investors' needs and long-term economic goals. Targeted interventions are needed for the poorest groups, where the lack of access to infrastructure, markets and services remain barriers to growth and poverty reduction. These interventions should include specific strategies to increase access to resources and markets, health insurance, and ensuring long-term investments in education and skills training. As human development and gender relations are structurally different across ethnic groups, policies should be tailored to specific needs, capabilities and gender gaps.

1/ The MDG Progress Report for the Lao P.D.R. 2013, prepared by the Government of the Lao P.D.R. and the United Nations.

driver of growth, with government support, especially in the areas of agriculture and tourism. The strategy for growth will increasingly rely on fostering human capital through investment in health and education, spotlighting on expanding networks of rural health clinics and vocational training to anticipate future labor market demand. Decisions on public investment would be based more on expected social returns and reducing wastefulness. Moreover, the authorities realize the importance of high-quality and timely statistics in realizing Vision 2020, and the need for producing and disseminating these statistics in line with the international guidelines. They intend to make more use of IMF TA in national accounts, prices, government finance statistics, monetary and financial statistics, and balance of payments statistics.

STAFF APPRAISAL

28. Outlook and risks. Lao P.D.R. continues to make impressive development progress, and medium-term prospects remain favorable. The near-term outlook, however, is clouded by growing vulnerabilities induced by current macroeconomic policies, particularly the pressures from public sector employee compensation which is already well above the LIC average. These heightened vulnerabilities have manifested themselves in the recent fiscal stress and foreign currency liquidity shortage. Inflation pressures are expected to persist over the next two years. The current account deficit is expected to widen in 2013–14, and although FDI inflows should remain vigorous, reserve levels would remain inadequate. A deterioration of banks' asset quality from excessive credit growth could erode capital, raising concerns about domestic banking sector soundness. In addition to these policy-induced risks, the external position is also vulnerable to a slowdown in trading partners' growth and terms of trade shocks.

29. The time to act is now. These escalating pressures argue forcefully for the immediate tightening of fiscal and monetary policies to support the exchange rate anchor, replenish international reserves, build up fiscal buffers, and guide the economy toward a soft landing. To shift firmly toward a more sustainable growth path, the authorities would need to accept a more moderate near-term growth outcome than under the baseline projection. After macroeconomic stability is restored, continued institutional reforms to enhance private sector-led competition will lead to higher productivity and broader-based growth over time.

30. Fiscal policy. The commitment to fiscal consolidation is central to restoring macroeconomic stability. It would also bolster Lao P.D.R.'s moderate risk of external debt distress status and its ability to absorb future shocks. Communicating this commitment clearly will send a strong signal to investors, and facilitate future external debt issuance. Staff supports the authorities' determination to formulate a comprehensive medium-term budget strategy. This strategy should be anchored around a nonmining fiscal deficit target of no more than 5 percent of GDP starting from the current fiscal year to lower public debt to 40 percent of GDP by 2020. This target, which requires further tightening efforts, will help reduce near-term inflation and balance-of-payments pressures. In addition to measures to improve tax collection, which the authorities have started, staff would support a VAT rate increase. A political consensus is also needed to moderate the pace of future compensation increases and implement civil service reform. This would restore the fiscal space necessary for adequate level of capital and human development spending, including for paying down arrears related to public investment and poverty reduction outlays.

31. Monetary and exchange rate policy. The authorities' commitment to maintaining a stabilized exchange rate within a reasonably wide and adjustable band has contributed to increased confidence in the kip and de-dollarization efforts during the past decade. This exchange rate anchor now needs to be bolstered by tighter macroeconomic policies. Moreover, given the extent of the estimated real exchange rate overvaluation, the kip should be allowed to move in line with market conditions with a view toward gradually building up international reserves to four months of import cover. This exchange rate strategy along with the lower credit and broad money growth targets amid tighter fiscal policy will enhance financial sector resiliency and restore macroeconomic stability. To achieve a lower credit growth target, it will be necessary to mop up excess kip liquidity in the financial system, accelerate the unwinding of quasi-fiscal lending operations, and raise policy interest rates. In addition, the BOL should continue to reduce currency mismatch on the balance sheets of banks and their borrowers.

32. Financial supervision. Efforts to strengthen financial supervision should be intensified, with regulatory measures put in place to reduce leverage. All banks should be required to achieve the minimum mandated CAR of 8 percent, with riskier banks required to maintain higher CARs. The BOL should develop detailed plans to address supervisory weaknesses as well as a crisis contingency plan for the banking sector, and seek sustained technical assistance. Over time, these efforts along with a clear and uniformly applied accounting framework and an effective and prompt debt resolution process will help foster a resilient financial system. The IMF is ready to provide further technical assistance and training on financial stability and crisis management frameworks, as well as stress testing, and encourages the authorities' participation in an FSAP.

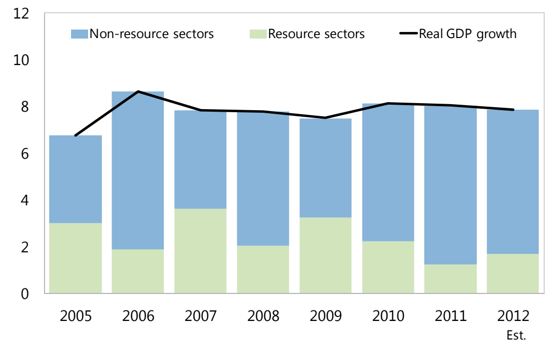
33. Sustainable and inclusive growth. The authorities' achievement in poverty reduction and progress toward MDGs is laudable. The focus on upgrading health and education infrastructure is the right one, and will contribute toward reducing inequality. Public sector financial management reforms will be crucial to improve the quality of public spending, and the IMF stands ready to provide technical assistance in this area. Looking forward, international trade integration will promote economic competition, which will in turn improve the business climate, promote institutional reform, statistical upgrades, and offer potential to make growth more productivity-driven and broader-based.

34. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Lao P.D.R.: Growth is Strong; Price Pressures are Picking Up

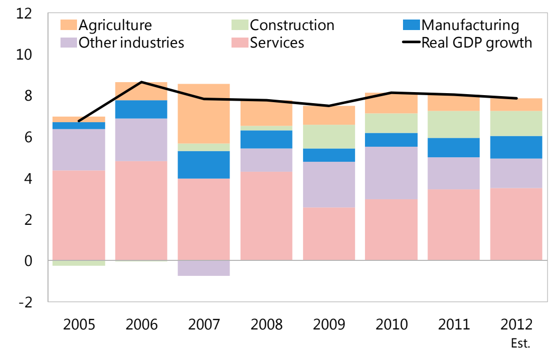
Growth remained close to 8 percent in 2012, …

Contribution to GDP Growth (2002 prices)
(In percent)



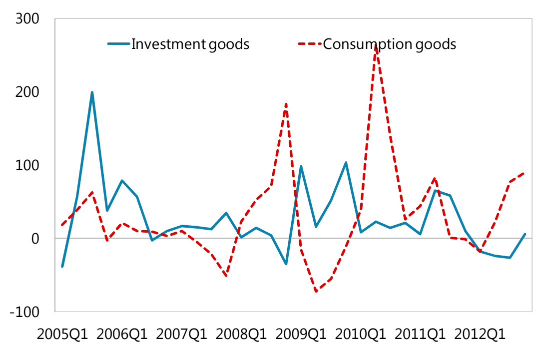
…with impetus from services, construction, and manufacturing, similar to 2011.

Contribution to GDP growth (2002 prices)
(In percent)



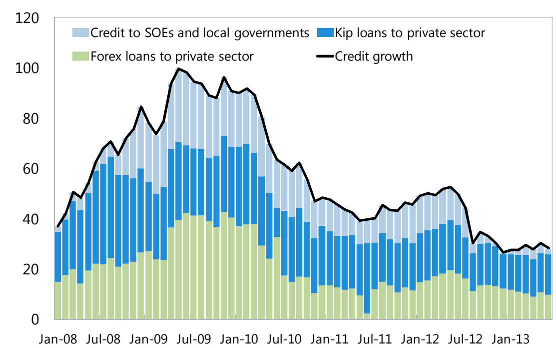
Official import data indicated strong consumption, while machinery and equipment imports weakened.

Import growth
(Year-on-year percent change)



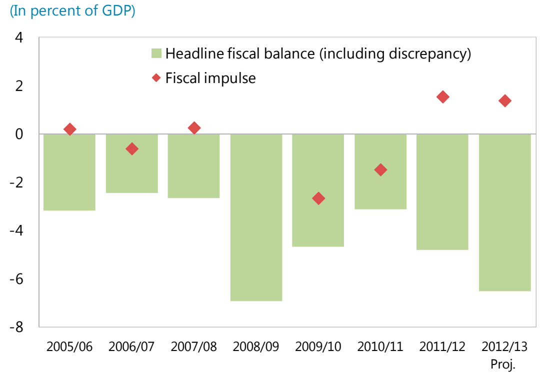
Activity continues to be supported by strong private credit growth, …

Contribution to Credit Growth
(Year-on-year percent change)



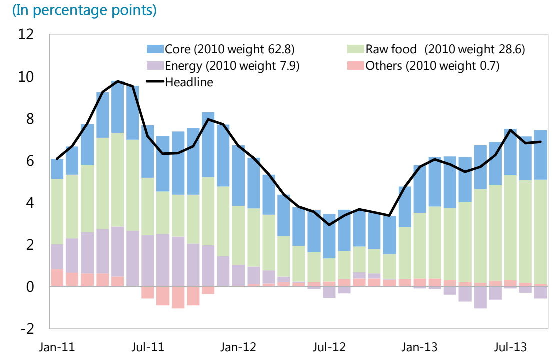
…, and stimulus from fiscal policy.

Fiscal Balance and Impulse 1/
(In percent of GDP)



Inflation is accelerating, mainly from fresh food. Core inflation has recently started to pick up.

Contribution to Headline Inflation 1/
(In percentage points)



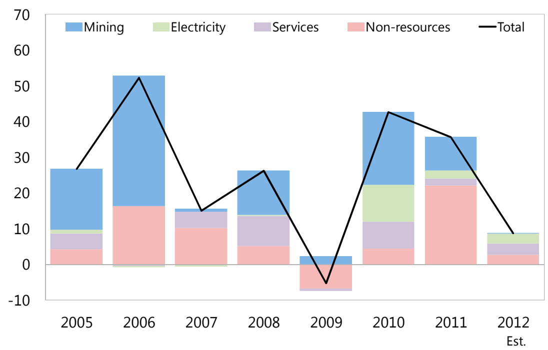
1/ Core inflation excludes raw food, fuel, gold, electricity tariffs.

Sources: Lao P.D.R. authorities; CEIC; IMF's *World Economic Outlook*; and IMF staff estimates.

Figure 2. Lao P.D.R.: External Vulnerabilities are Growing

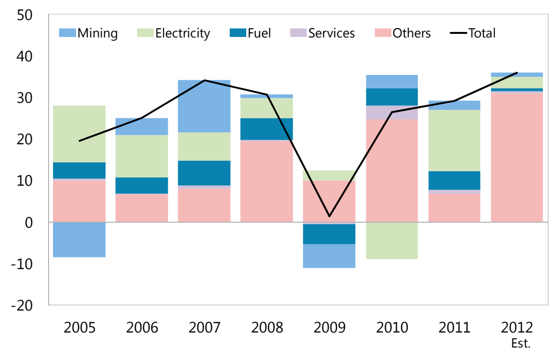
After two years of stellar performance, export growth weakened substantially in 2012.

Contribution to Export Growth
(In percentage points)



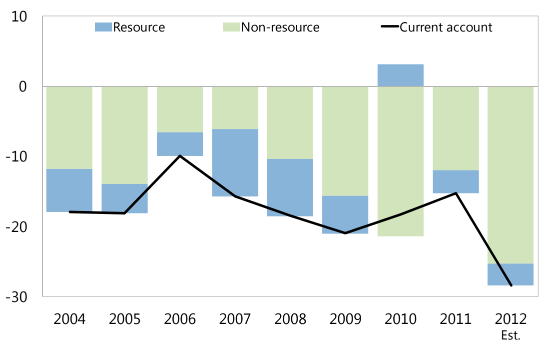
Meanwhile, nonresource imports surged to an unusually high level as preparation for the Asia Europe Meeting intensified.

Contribution to Import Growth
(In percentage points)



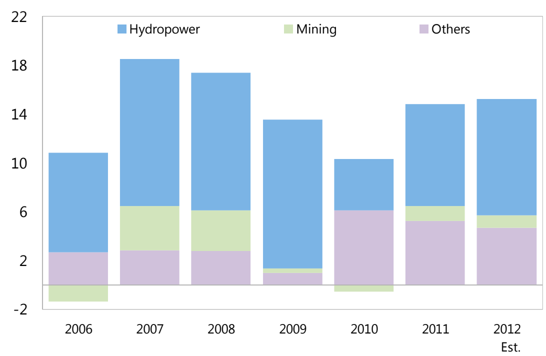
The result is a substantially worsened nonresource current account position.

Current Account Balance
(In percent of GDP)



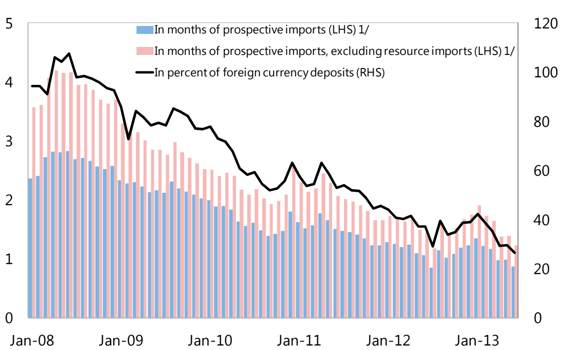
FDI remains vigorous. While the bulk of new FDI is still dominated by hydropower projects, foreign-funded investment in other sectors is strong.

FDI, Private Sector
(In percent of GDP)



Nevertheless, the international reserves position is at its weakest in a decade, and remains inadequate.

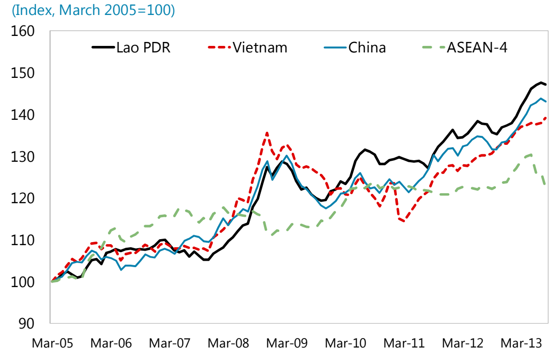
International Reserves



1/ 12-month moving average

Sharp real exchange rate appreciation threatens to erode external competitiveness further.

Real Effective Exchange Rates 1/
(Index, March 2005=100)



1/ ASEAN-4 includes Indonesia, Malaysia, Philippines and Thailand.

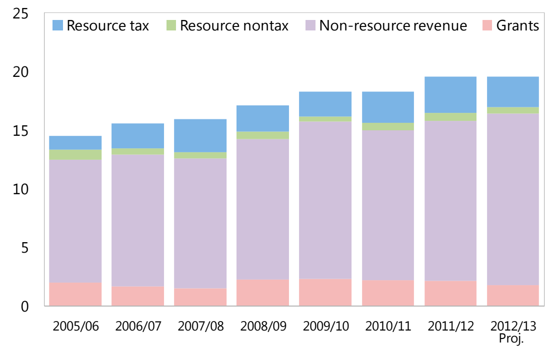
Sources: Lao P.D.R. authorities; CEIC; IMF's *World Economic Outlook*; and IMF staff estimates.

Figure 3. Lao P.D.R.: Fiscal Performance Gains have been Reversed

Overall revenue performance was strong in FY2012/13 from nonresource revenue gains. Mining revenue weakened from lower commodity prices.

Government Revenue and Grants

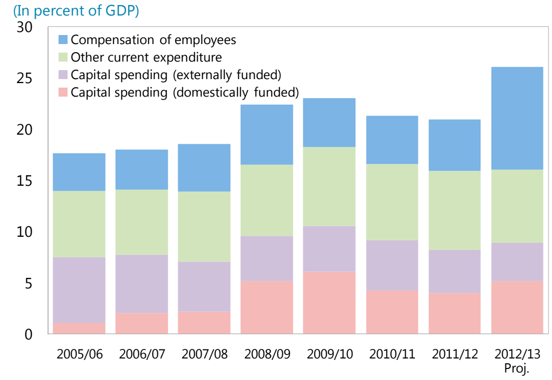
(In percent of GDP)



Expenditures surged from public pay increases and capital spending, which was not retrained like in FY 2011/12.

Government Expenditure

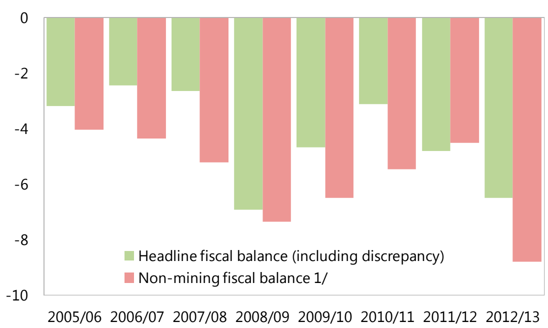
(In percent of GDP)



As a result, both overall and nonmining fiscal deficits are on the rise, reversing the trend observed since 2009, …

Fiscal Balance

(In percent of GDP)

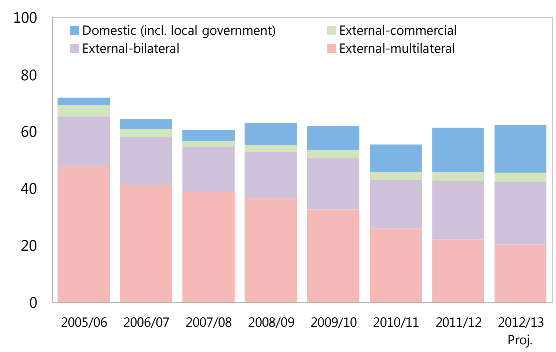


1/ Net lending/borrowing minus mining revenues. Proj.

…, and causing domestic public debt to rise sharply.

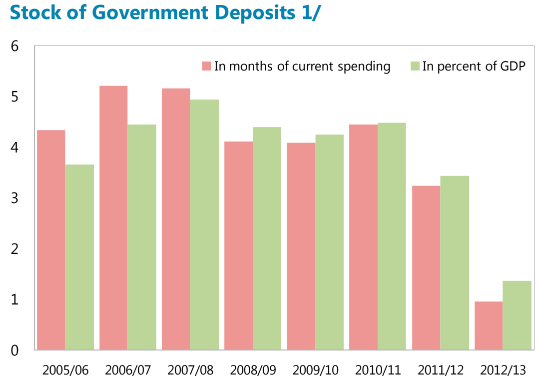
Public Sector Debt

(In percent of GDP)



With larger financing needs, the stock of government deposits has declined dramatically.

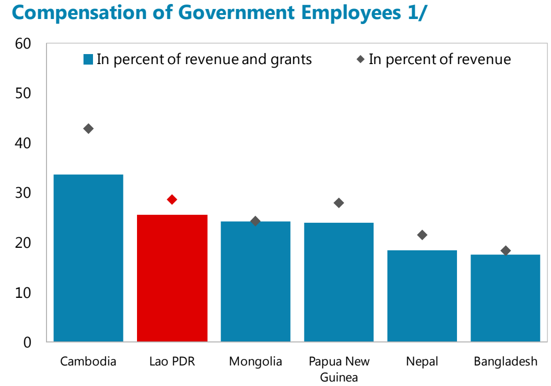
Stock of Government Deposits 1/



1/ For FY 2012/13, stock of government deposits are as of June 2013.

Even before the FY2012/13 wage increase, the share of public sector compensation in Lao P.D.R.'s revenue was already on the high side.

Compensation of Government Employees 1/



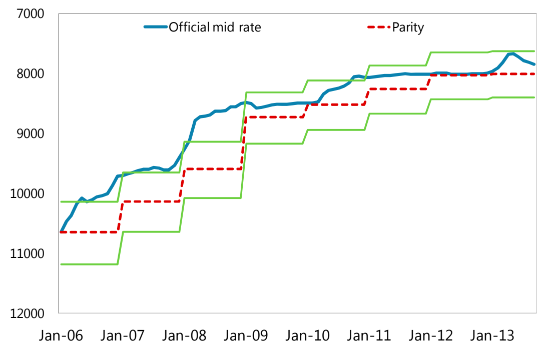
1/ Latest available year as of 2012.

Sources: Lao P.D.R. authorities; CEIC; IMF's *World Economic Outlook*; and IMF staff estimates.

Figure 4. Lao P.D.R.: Domestic Monetary and Credit Conditions Remain Highly Accommodative

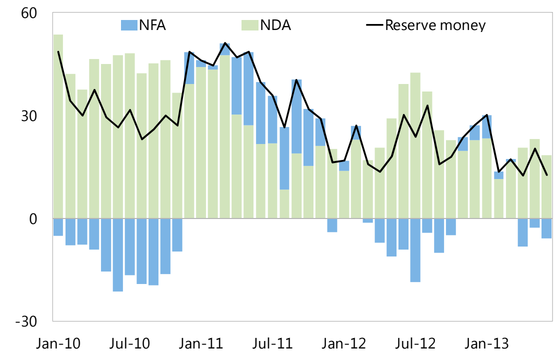
The Kip approached the upper end of the +/-5 percent band in early 2013, but has since depreciated against the US dollar.

Exchange Rates
(Kip/USD)



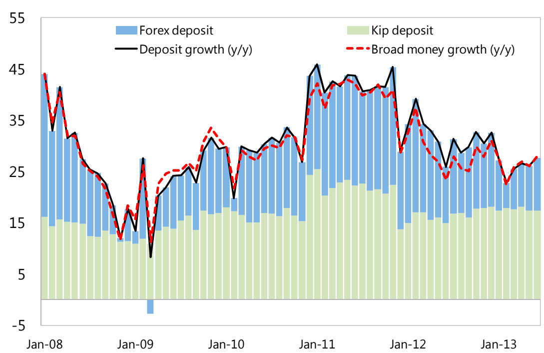
With weak international reserves gains, reserve money is driven by central bank lending to the government and SOEs.

Contribution to Reserve Money Growth
(In percentage points)



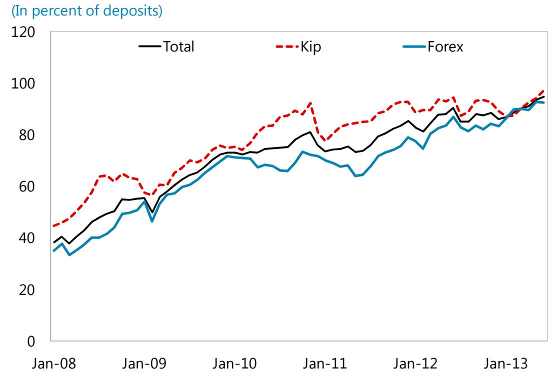
Broad money and deposit growth has slowed, but continues to be brisk, ...

Broad Money and Deposit Growth
(Year-on-year contribution in percentage points)



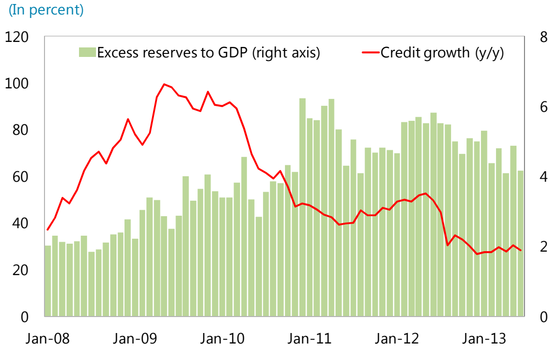
... while banks' risk appetite continues to push up loans against the deposit base.

Claims on the Economy, Commercial Banks
(In percent of deposits)



Kip liquidity remains ample, and banks have plenty of room to expand credit supply.

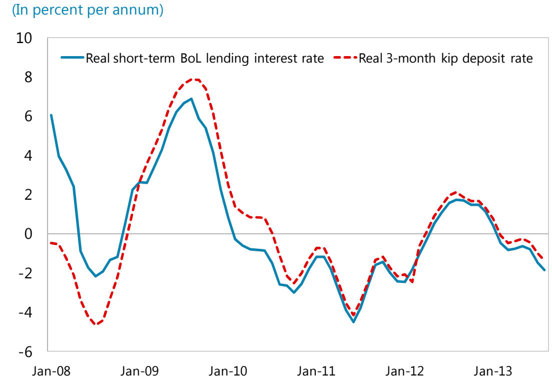
Credit to the Economy and Excess Reserves
(In percent)



Sources: BoL; and IMF staff estimates.

Without pressure on interest rates to rise, real interest rates have again become negative with rising inflation.

Real Interest Rate
(In percent per annum)



Sources: Lao P.D.R. authorities; CEIC; IMF's *World Economic Outlook*; and IMF staff estimates.

Appendix 1. Lao P.D.R.: Risk Assessment Matrix (RAM) 1/

Risk	Likelihood	Potential Impact	Policy Response
Protracted economic and financial volatility, especially for emerging markets (triggered by prospective exit from UMP).	**High** Prospects of higher interest rates in advanced economies could trigger a sustained reversal of capital flows from the region, intensifying foreign currency liquidity strains.	**Medium** Pressure on international reserves and the exchange rate, with effects on balance sheets, and potentially, a reacceleration of dollarization.	Allow the currency to depreciate and refrain from domestic demand stimulus to preserve limited international reserves and contain inflation.
Lower than anticipated emerging market growth potential (earlier maturing of the cycle and incomplete structural reforms with spillovers to LICs and advanced economies).	**Medium** Growth relies to a large extent on trade and FDI links with other Asian countries, particularly China, Thailand and Vietnam.	**Medium** Slowdown in trading partner growth will put pressure on the balance of payments as exports decline and domestic demand continues to be stimulated by expansionary policies. Could lead to further pressure on exchange rate and international reserves.	Allow the currency to depreciate and avoid stimulating domestic demand to preserve limited external buffers and contain inflation. Over time, take advantage of WTO to diversify export destinations.
Loss of confidence in the domestic banking system caused by a sharp loss of international reserves.	**Medium** International reserves are low and expansionary monetary and fiscal policies threaten to deplete them further.	**High** Loss of confidence in the currency leading to currency substitution, capital flight and exchange rate pressure, with effects on bank and corporate balance sheets and a prolonged downturn in growth.	Activate banking sector contingency plan, including depositor protection. Inject kip liquidity to solvent banks. Preserve international reserves by allowing the currency to depreciate and limiting fiscal expansion. Strengthen banking supervision.
Terms-of-trade shock (particularly declining global copper and gold prices).	**Medium** Growth relies on exports of commodities and imports of intermediate goods and petroleum products.	**Medium** Pressure on the balance of payments, exchange rate and international reserves.	Increase exchange rate flexibility and avoid stimulating domestic demand to preserve limited international reserves; Over time, diversify exports.
Reversal of fiscal consolidation	**Medium** Pressure for greater spending and response to external shocks or natural disasters could lead to an increase in the debt ratio.	**Medium** Crowding out of public and private productive investments and social spending, and overvaluation of the real exchange rate could lead to a slower or stagnating growth in the medium-term.	Continue fiscal consolidation, improve nonmining revenue collection, and rationalize expenditure, with a focus on fostering physical and human capital.

1/ Assumes no policy response to external shocks. The RAM shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 percent and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the sources of risks and the overall level of concern as of the time of discussion with the authorities.

Table 1. Lao P.D.R.: Selected Economic and Financial Indicators, 2010–14[1/]

	2010	2011	2012	2013	2014
			Est.	Proj.	
GDP and prices (percentage change)					
Real GDP growth	8.1	8.0	7.9	8.2	7.5
CPI (annual average)	6.0	7.6	4.3	6.5	7.5
CPI (end year)	5.8	7.7	4.7	7.4	7.7
Public finances (in percent of GDP)					
Revenue	18.3	18.3	19.6	19.6	20.6
Of which : Resources	2.6	3.3	3.8	3.2	3.4
Of which : Mining	1.8	2.5	3.1	2.3	2.5
Of which : Hydro power	0.8	0.8	0.8	0.9	0.9
Of which : Grant	2.3	2.2	2.1	1.8	1.7
Expenditure	23.0	21.3	21.0	26.1	24.5
Expense	12.5	12.1	12.7	17.2	16.7
Net acquisition of nonfinancial assets 2/	10.6	9.2	8.2	8.9	7.8
Net lending/borrowing	-4.7	-3.0	-1.4	-6.5	-3.8
Net lending/borrowing including discrepancy	-4.7	-3.1	-4.8	…	…
Nonmining balance 3/	-6.5	-5.5	-4.5	-8.8	-6.4
Nonmining balance including discrepancy 3/	-6.5	-5.6	-7.9	…	…
Money and credit (annual percent change)					
Reserve money	48.6	16.2	27.2	12.7	14.9
Broad money	39.5	28.7	31.0	24.7	20.8
Bank credit to the economy 4/	48.4	45.8	26.6	32.9	19.4
Bank credit to the private sector	48.4	39.3	35.1	34.2	21.0
Balance of payments					
Exports (in millions of U.S. dollars)	2,196	3,120	3,323	3,451	3,661
In percent change	44.4	42.1	6.5	3.9	6.1
Imports (in millions of U.S. dollars)	3,574	4,635	6,355	6,940	7,242
In percent change	23.6	29.7	37.1	9.2	4.4
Current account balance (in millions of U.S. dollars)	-1,251	-1,243	-2,606	-2,946	-2,956
In percent of GDP	-18.2	-15.2	-28.4	-29.5	-27.3
Gross official reserves (in millions of U.S. dollars)	728	677	740	666	712
In months of prospective goods and services imports	1.8	1.2	1.2	1.1	1.1
(Excluding imports associated with large resource projects)	2.6	1.7	1.7	1.5	1.5
External public debt and debt service					
External public debt					
In millions of U.S. dollars	3,539	3,664	4,221	4,611	5,167
In percent of GDP	50.3	44.8	46.1	47.4	49.1
External public debt service					
In percent of exports	4.4	2.7	4.1	5.6	5.4
Exchange rate					
Official exchange rate (kip per U.S. dollar; end-of-period)	8,040	8,002	7,992	…	…
Real effective exchange rate (2000=100)	125.2	127.6	133.7	…	…
Nominal GDP					
In billions of kip	56,523	65,398	73,257	82,260	94,041
In millions of U.S. dollars	6,855	8,162	9,169	10,002	10,814

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

1/ Public finances are on a fiscal year (October to September) while other data are on a calendar year.
2/ Includes off-budget investment expenditures.
3/ Net lending/borrowing excluding mining revenue.
4/ Includes Bank of Lao P.D.R. lending to state-owned enterprises and subnational levels of government.

Table 2. Lao P.D.R.: Balance of Payments, 2010–14

	2010	2011	2012 Est.	2013 Projection	2014
	(In millions of U.S. dollars; unless otherwise indicated)				
Current account	-1,251	-1,243	-2,606	-2,946	-2,956
Merchandise trade balance	-1,379	-1,515	-3,032	-3,489	-3,581
Exports, f.o.b.	2,196	3,120	3,323	3,451	3,661
Mining and hydropower	1,500	1,821	1,924	1,868	1,873
Other exports	696	1,299	1,399	1,583	1,788
Imports, c.i.f.	3,574	4,635	6,355	6,940	7,242
Mining and hydropower	728	1,447	1,648	2,109	2,161
Mining projects	354	436	488	475	360
Hydropower projects	374	1,012	1,161	1,634	1,801
Petroleum imports	412	585	626	655	674
Other imports	2,434	2,602	4,081	4,176	4,407
Services (net)	374	396	496	539	580
Of which: Tourism	382	406	506	557	612
Income (net)	-425	-336	-315	-265	-249
Interest payments	-135	-115	-147	-165	-158
Of which: Public	-41	-27	-59	-86	-87
Mining and hydropower	-86	-82	-81	-71	-63
Mining projects	-6	-10	-14	-10	-9
Hydropower projects	-79	-72	-67	-61	-54
Dividends and profit repatriation	-525	-616	-544	-467	-437
Of which: Mining and hydropower	-470	-561	-487	-409	-377
Other	235	394	376	368	347
Transfers (net)	179	213	246	269	293
Private	70	84	101	111	122
Official	109	129	145	158	171
Capital and financial account	1,353	1,198	2,670	2,876	3,006
Public sector	155	145	308	390	556
Disbursements	231	220	412	541	711
Amortization	-77	-74	-104	-151	-155
Banking sector (net)	-29	23	39	240	39
Private sector	1,227	1,030	2,323	2,246	2,411
Foreign direct investment (net) 1/	671	1,210	1,399	1,846	2,011
Of which: Mining and hydropower projects	250	783	969	1,343	1,552
Of which: Mining projects	-37	102	94	81	-30
Hydropower projects	287	681	875	1,262	1,582
Other private flows and errors and omissions	556	-180	925	400	400
Overall balance	102	-45	65	-70	50
Core Balance (CA+FDI+ODA)	-425	66	-942	-753	-446
Financing	-102	45	-65	70	-50
Central bank net foreign assets	-102	45	-65	70	-50
Assets (increase -)	-95	51	-62	74	-46
Liabilities (reduction -)	-7	-6	-3	-4	-4
Memorandum items:					
Current account balance (in percent of GDP)	-18.2	-15.2	-28.4	-29.5	-27.3
Excluding official transfers	-19.8	-16.8	-30.0	-31.0	-28.9
Resource current account balance (in percent of GDP) 2/	3.2	-3.3	-3.2	-7.2	-6.7
Nonresource current account balance (in percent of GDP)	-21.4	-11.9	-25.2	-22.2	-20.6
Exports (annual percent change)	44.4	42.1	6.5	3.9	6.1
Mining and hydropower	64.5	21.4	5.7	-2.9	0.2
Other exports	14.3	86.7	7.7	13.2	13.0
Imports (annual percent change)	23.6	29.7	37.1	9.2	4.4
Of which: Hydropower and mining related	-18.6	98.8	13.9	27.9	2.5
other imports	42.6	6.9	56.8	2.3	5.5
Oil imports	41.5	42.0	6.9	4.8	2.9
Gross official reserves	728	677	740	666	712
In months of prospective imports of goods and nonfactor services	1.8	1.2	1.2	1.1	1.1
(Excluding imports associated with large resource projects)	2.6	1.7	1.7	1.5	1.5
Nominal GDP at market prices	6,855	8,162	9,169	10,002	10,814

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, 2009/10–2013/14

	2009/10	2010/11	2011/12	2012/13 Proj.	2013/14 Proj.
	(In billions of kip)				
Revenue	9,779	11,571	13,960	15,666	18,787
Of which: Resource revenue 1/	1,376	2,098	2,716	2,533	3,126
Taxes	7,503	9,109	10,915	12,490	15,313
Income and profit taxes	1,587	2,136	2,940	3,072	4,173
Income taxes	462	543	744	949	1,294
Profit taxes	1,125	1,592	2,196	2,123	2,879
Of which: Mining	487	888	1,287	1,069	1,513
Of which: Nonmining	638	705	909	1,054	1,366
VAT	1,869	2,403	2,827	3,201	3,663
Excise duties	1,687	1,948	2,344	2,554	2,965
Import duties	832	965	1,047	1,546	2,155
Royalties	560	722	884	946	1,024
Other taxes	968	936	872	1,172	1,332
Other revenues	1,035	1,073	1,513	1,738	1,932
Grants	1,242	1,389	1,532	1,438	1,542
Expenditure	12,302	13,461	14,945	20,875	22,294
Expense	6,656	7,652	9,065	13,725	15,220
Compensation of employees	2,525	2,940	3,560	8,000	8,800
Transfers	1,698	1,866	2,015	2,244	2,649
Interest payments	398	431	591	962	925
Of which: External	318	373	473	612	725
Other recurrent	2,034	2,415	2,899	2,519	2,846
Net acquisition of nonfinancial assets	5,646	5,808	5,881	7,150	7,074
Domestically financed	3,271	2,699	2,876	4,150	4,250
Of which: Off-budget	1,823	1,130	314	1,200	1,000
Externally financed	2,376	3,109	3,005	3,001	2,824
Net lending/borrowing	-2,524	-1,889	-986	-5,209	-3,507
Net acquisition of financial assets	-59	-408	565	1,987	121
Domestic	-59	-408	565	1,987	121
Foreign	0	0	0	0	0
Net incurrence of liabilities	2,559	2,379	2,866	3,222	3,628
Domestic	1,708	1,116	1,828	2,178	1,992
Foreign	851	1,262	1,038	1,043	1,636
Discrepancy	-24	82	2,446	0	0
Memorandum items:					
Net lending including discrepancy	-2,500	-1,971	-3,431	...	...
Nonmining balance 2/	-3,478	-3,456	-3,218	-7,038	-5,809
Operating balance	3,123	3,919	4,895	1,941	3,567
Mining revenue	954	1,567	2,232	1,829	2,302
Hydropower revenue	422	530	484	705	824
Nonresource revenue	7,161	8,085	9,711	11,695	14,119
GDP	53,438	63,179	71,292	80,009	91,096

Table 3. Lao P.D.R.: General Government Operations, 2009/10–2013/14 (concluded)

	2009/10	2010/11	2011/12	2012/13 Proj.	2013/14 Proj.
	(In percent of GDP, unless otherwise indicated)				
Revenue	18.3	18.3	19.6	19.6	20.6
Of which: Resource revenue 1/	2.6	3.3	3.8	3.2	3.4
Taxes	14.0	14.4	15.3	15.6	16.8
Income and profit taxes	3.0	3.4	4.1	3.8	4.6
Income taxes	0.9	0.9	1.0	1.2	1.4
Profit taxes	2.1	2.5	3.1	2.7	3.2
Of which: Mining	0.9	1.4	1.8	1.3	1.7
Of which: Nonmining	1.2	1.1	1.3	1.3	1.5
VAT	3.5	3.8	4.0	4.0	4.0
Excise duties	3.2	3.1	3.3	3.2	3.3
Import duties	1.6	1.5	1.5	1.9	2.4
Royalties	1.0	1.1	1.2	1.2	1.1
Other taxes	1.8	1.5	1.2	1.5	1.5
Other revenues	1.9	1.7	2.1	2.2	2.1
Grants	2.3	2.2	2.1	1.8	1.7
Expenditure	23.0	21.3	21.0	26.1	24.5
Expense	12.5	12.1	12.7	17.2	16.7
Compensation of employees	4.7	4.7	5.0	10.0	9.7
Transfers	3.2	3.0	2.8	2.8	2.9
Interest payments	0.7	0.7	0.8	1.2	1.0
Of which: External	0.6	0.6	0.7	0.8	0.8
Other recurrent	3.8	3.8	4.1	3.1	3.1
Net acquisition of nonfinancial assets	10.6	9.2	8.2	8.9	7.8
Domestically financed	6.1	4.3	4.0	5.2	4.7
Of which: Off-budget	3.4	1.8	0.4	1.5	1.1
Externally financed	4.4	4.9	4.2	3.8	3.1
Net lending/borrowing	-4.7	-3.0	-1.4	-6.5	-3.8
Net acquisition of financial assets	-0.1	-0.6	0.8	2.5	-0.1
Domestic	-0.1	-0.6	0.8	2.5	-0.1
Foreign	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	4.8	3.8	4.0	4.0	4.0
Domestic	3.2	1.8	2.6	2.7	2.2
Foreign	1.6	2.0	1.5	1.3	1.8
Discrepancy	0.0	0.1	3.4	0.0	0.0
Memorandum items:					
Net lending including discrepancy	-4.7	-3.1	-4.8	…	…
Nonmining balance 2/	-6.5	-5.5	-4.5	-8.8	-6.4
Operating balance	5.8	6.2	6.9	2.4	3.9
Mining revenue	1.8	2.5	3.1	2.3	2.5
Hydropower revenue	0.8	0.8	0.7	0.9	0.9
Nonresource revenue	13.4	12.8	13.6	14.6	15.5
GDP	53,438	63,179	71,292	80,009	91,096

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/ Net lending/borrowing minus mining revenues.

Table 4. Lao P.D.R.: Monetary Survey, 2010–14

	2010	2011	2012				2013				2014
	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Dec.
										Proj.	
	(In billions of kip, unless otherwise indicated)										
Bank of Lao P.D.R. (BoL)											
Net foreign assets	5,151	4,772	4,727	4,220	4,131	5,255	4,833	3,529	3,952	4,992	5,721
In millions of U.S. dollars	639	595	593	527	517	660	625	455	504	590	640
Net domestic assets	4,409	6,341	7,394	7,615	7,512	8,878	9,379	9,802	9,283	10,935	12,572
Government (net)	-742	-653	43	-271	-97	630	606	711	753	846	821
Claims	926	688	883	929	929	1,228	1,218	1,113	1,113	1,247	1,247
Deposits	-1,667	-1,341	-840	-1,200	-1,026	-598	-612	-402	-360	-401	-426
Of which: Foreign currency	-1,243	-1,091	-618	-794	-708	-504	-409	-344	-340	-307	-326
State-owned enterprises	3,367	4,997	5,228	5,554	4,764	4,959	5,964	5,890	5,359	6,214	7,076
Of which: Kip	419	1,255	1,348	1,429	1,725	1,980	2,446	2,804	2,971	2,958	3,368
Local governments	3,071	4,701	4,932	5,259	4,468	4,664	5,668	5,594	5,063	5,918	6,781
Banks	1,936	3,168	3,188	3,342	3,287	3,647	3,658	3,837	4,078	4,197	4,747
BoL securities	-1,023	-2,145	-2,003	-2,025	-2,014	-1,786	-2,000	-2,194	-2,147	-2,000	-2,000
Other items (net)	872	974	938	1,016	1,572	1,428	1,151	1,558	1,240	1,678	1,928
Reserve money	9,560	11,113	12,120	11,836	11,643	14,133	14,212	13,331	13,236	15,926	18,293
Currency in circulation	4,505	5,661	5,777	5,370	5,550	7,169	7,517	7,079	7,165	8,300	9,533
Bank Reserves	5,056	5,452	6,343	6,465	6,093	6,964	6,695	6,252	6,071	7,626	8,760
Of which: Foreign currency	1,850	2,304	2,680	2,732	2,575	2,943	2,829	2,642	2,565	3,223	3,702
Monetary survey											
Net foreign assets	6,280	5,711	6,667	3,787	4,366	5,879	4,501	1,635	2,250	3,624	3,930
In millions of U.S. dollars	779	712	836	473	546	738	582	211	287	429	440
Of which: Commercial banks	140	117	243	-54	29	78	-43	-244	-217	-162	-200
Net domestic assets	14,889	21,535	23,101	25,506	27,254	29,826	32,964	35,823	36,689	40,905	49,855
Government (net)	-481	-1,211	-1,123	-892	540	2,032	1,838	2,411	2,571	3,320	4,555
Budget	-1,068	-1,799	-1,710	-1,479	-47	1,444	1,250	1,823	1,984	2,733	3,967
Claims	1,387	929	1,684	1,913	2,401	2,976	3,291	2,911	3,058	3,620	4,854
Deposits	-2,455	-2,727	-3,394	-3,392	-2,448	-1,532	-2,041	-1,088	-1,075	-887	-887
Other	588	588	588	588	588	588	588	588	588	588	588
Credit to the economy	16,537	24,104	26,428	28,221	28,706	30,525	34,243	36,183	37,710	40,555	48,421
In kip	6,923	10,927	11,763	12,751	13,868	14,909	16,906	18,667	19,951	20,950	25,096
In foreign currencies	9,614	13,177	14,665	15,470	14,838	15,616	17,337	17,516	17,759	19,605	23,325
Of which: Private credit	12,712	17,713	19,782	21,202	22,395	23,934	26,538	28,501	30,578	32,119	38,864
Other items (net)	-1,167	-1,358	-2,205	-1,823	-1,993	-2,730	-3,117	-2,771	-3,593	-2,971	-3,121
Broad money	21,169	27,246	29,768	29,293	31,621	35,705	37,465	37,458	38,938	44,529	53,785
Currency in circulation	3,800	4,844	4,738	4,215	4,437	6,020	6,064	5,457	5,574	6,744	8,146
Kip deposits	8,056	10,453	11,621	12,026	13,040	14,517	16,038	16,374	16,703	19,276	23,283
Foreign currency deposits (FCDs)	9,313	11,949	13,409	13,052	14,143	15,169	15,364	15,627	16,662	18,509	22,356
	(Annual percent change, unless otherwise indicated)										
Reserve money	48.6	16.2	15.8	30.2	15.8	27.2	17.3	12.6	13.7	12.7	14.9
Broad money	39.5	28.7	30.8	23.3	25.1	31.0	25.9	27.9	23.1	24.7	20.8
Credit to the economy	48.4	45.8	49.3	49.8	34.7	26.6	29.6	28.2	31.4	32.9	19.4
Credit to the private sector	48.4	39.3	47.7	49.9	40.0	35.1	34.2	34.4	36.5	34.2	21.0
Memorandum items:											
Velocity	2.67	2.40	2.46	2.50	2.32	2.05	2.20	2.20	2.11	1.85	1.75
Money multiplier	2.21	2.45	2.46	2.47	2.72	2.53	2.64	2.81	2.94	2.80	2.94
Loan/deposit (percent)	75.8	85.3	84.7	90.4	88.1	86.1	90.1	94.7	97.0	90.9	90.6
In kip (percent)	80.7	92.5	89.6	94.1	93.1	89.1	90.2	96.9	101.7	93.3	93.3
In foreign currency (percent)	71.6	79.0	80.4	86.9	83.4	83.3	90.0	92.3	92.3	88.3	87.8
Gross official reserves (in millions of U.S. dollars)	728	677	675	608	598	740	704	532	583	666	712
Net international reserves (in millions of U.S. dollars) 1/	410	308	257	186	195	290	259	114	177	209	226
Exchange rate, end-of-period (kip per U.S. dollar)	8,058	8,023	7,976	8,006	7,990	7,966	7,735	7,753	7,840	...	...
Nominal GDP (in billions of kip)	56,523	65,398	73,257	73,257	73,257	73,257	82,260	82,260	82,260	82,260	94,041
Dollarization rate (FCDs/broad money; in percent)	44.0	43.9	45.0	44.6	44.7	42.5	41.0	41.7	42.8	41.6	41.6
Gross reserve/Reserve Money	61	49	44	41	41	42	38	31	35	35	35
Required reserves	1,023	1,515	1,643	1,629	1,764	1,778	1,753	1,834	2,001	2,248	2,715
Excess reserves (percent of GDP)	6.2	4.8	5.6	5.8	5.0	5.0	4.8	4.2	3.7	4.4	4.3

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.

Table 5. Lao P.D.R.: Medium-Term Macroeconomic Framework, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Est.			Projections			
Output and prices			(Percent change, unless otherwise indicated)						
Real GDP	8.1	8.0	7.9	8.2	7.5	7.8	8.0	7.7	7.5
Consumer prices (end-period)	5.8	7.7	4.7	7.4	7.7	7.3	6.6	5.5	5.8
Consumer prices (annual average)	6.0	7.6	4.3	6.5	7.5	7.5	7.6	6.0	5.7
GDP per capita (in U.S. dollars)	1,064	1,244	1,371	1,468	1,557	1,688	1,841	2,020	2,237
Public finances (in percent of GDP) 1/									
Revenue	18.3	18.3	19.6	19.6	20.6	21.2	21.1	20.9	20.7
Tax and nontax revenue	16.0	16.1	17.4	17.8	18.9	19.5	19.5	19.3	19.3
Mining	1.8	2.5	3.1	2.3	2.5	2.1	1.9	1.7	1.6
Hydro power	0.8	0.8	0.7	0.9	0.9	1.0	1.0	0.9	0.9
Others	13.4	12.8	13.6	14.6	15.5	16.5	16.6	16.7	16.8
Grant	2.3	2.2	2.1	1.8	1.7	1.7	1.6	1.5	1.4
Expenditure	23.0	21.3	21.0	26.1	24.5	26.7	25.5	24.7	23.9
Expense	12.5	12.1	12.7	17.2	16.7	18.5	18.0	17.9	17.4
Net acquisition of nonfinancial assets 2/	10.6	9.2	8.2	8.9	7.8	8.2	7.5	6.8	6.5
Net lending/borrowing	-4.7	-3.0	-1.4	-6.5	-3.8	-5.5	-4.4	-3.8	-3.3
Net lending/borrowing including disrepancy	-4.7	-3.1	-4.8	...	...	...	...	...	...
Nonmining balance 3/	-6.5	-5.5	-4.5	-8.8	-6.4	-7.5	-6.3	-5.6	-4.8
Nonmining balance including discrepancy 3/	-6.5	-5.6	-7.9	...	...	...	...	...	...
Balance of payments			(In millions of U.S. dollars; unless otherwise indicated)						
Current account balance	-1,251	-1,243	-2,606	-2,946	-2,956	-2,831	-2,579	-2,522	-2,855
In percent of GDP	-18.2	-15.2	-28.4	-29.5	-27.3	-23.7	-19.4	-17.0	-17.0
Exports	2,196	3,120	3,323	3,451	3,661	3,997	4,658	5,124	5,507
Of which: Resources	1,500	1,821	1,924	1,868	1,873	1,976	2,373	2,543	2,585
In percent change	44.4	42.1	6.5	3.9	6.1	9.2	16.5	10.0	7.5
Of which: Resources	64.5	21.4	5.7	-2.9	0.2	5.5	20.1	7.1	1.7
Imports	3,574	4,635	6,355	6,940	7,242	7,488	7,825	8,330	9,173
In percent change	23.6	29.7	37.1	9.2	4.4	3.4	4.5	6.4	10.1
Of which: Resources	-18.6	98.8	13.9	27.9	2.5	-7.8	-12.5	-15.8	4.4
Services and income (net)	-51	59	181	274	332	336	230	301	400
Transfers	179	213	246	269	293	323	358	383	410
Capital account balance	1,353	1,198	2,670	2,876	3,006	3,012	2,909	2,865	3,121
Of which: FDI	671	1,210	1,399	1,846	2,011	2,015	1,938	1,970	2,296
Overall balance	102	-45	65	-70	50	181	330	344	267
Debt and debt service									
Public debt (in percent of GDP)	59.1	56.2	61.8	63.5	65.4	65.9	65.5	61.9	57.6
External debt (in percent of GDP)	87.1	84.0	89.9	110.8	127.8	133.6	127.4	120.7	113.2
External public debt (in percent of GDP)	50.3	44.8	46.1	47.4	49.1	49.2	48.2	46.0	43.0
External public debt service (in percent of exports)	4.4	2.7	4.1	5.6	5.4	5.1	4.6	4.4	4.2
Gross official reserves									
In millions of U.S. dollars	728	677	740	666	712	889	1,215	1,555	1,818
In months of imports (excluding resource projects)	2.6	1.7	1.7	1.5	1.5	1.7	2.0	2.3	2.5
Memorandum items:									
Nominal GDP (in billions of kip)	56,523	65,398	73,257	82,260	94,041	109,595	127,895	148,818	173,464

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

1/ Fiscal year basis (October to September).
2/ Includes off-budget investment expenditures.
3/ Net lending/borrowing minus mining revenue.

Table 6. Lao P.D.R.: Millennium Development Goals (MDG) Indicators

MDGs	Indicator	Baseline	Current Status	2015 Target
1. Eradicate extreme poverty and hunger	Proportion of population below the national poverty line	46	27.6	24
	Employment-to-population ratio	47	77.7	no target
	Prevalence of underweight children under five years of age	44	27	22
	Prevalence of stunting in children under five years of age	48	38	34
2. Achieve universal primary Education	Proportion of pupils starting grade 1 who reach grade 5	48	70	95
	Literacy rate in the age group of 15–24 years	71	73.1	99
3. Promote gender equality and empower Women	Number of girls per 100 boys enrolled in:			
	Primary	77	91	100
	Lower secondary	66	89	100
	Upper secondary	56	83	100
	Tertiary	49	77	100
	Share of women in wage employment	38	34	no target
4. Reduce child mortality	Under–five mortality rate	170	79	55
	Proportion of one-year-old children immunized against measles	41.8	55	90
5. Improve maternal Health	Proportion of births attended by skilled birth personnel	14	42	49
	Maternity mortality rate (per 100,000 live births)	…	357	80
6. Combat HIV/AIDS, malaria and other diseases	HIV prevalence among general pop. (percentage)	0.006	0.1	less than 1
7. Ensure Environmental Sustainability	Proportion of land areas covered by forests (percentage)	70	40.3	65
	Consumption of ozone-depleting substances (mt)	50	2.5	0

Source: United Nations and Government of Lao P.D.R., "The Millenium Development Goals, Progress Report for the Lao P.D.R., 2013", (http://www.undp.org/content/lao_pdr/en/home/library/mdg/mdgs-progress-report-lao-pdr-2013).

INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS[1]

October 31, 2013

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Lao P.D.R.'s risk of debt distress remains moderate.[2] *Although all external debt distress indicators remain below the policy-dependent indicative thresholds during the projection period under the baseline scenario, the thresholds are breached in the presence of certain shocks. Compared to last year's DSA, the PV of external debt to GDP ratio is closer to the threshold, leaving few buffers in case of any adverse shock. Also, while debt service ratios remain within the policy-dependent indicative thresholds, primarily because of the high level of concessionality of official borrowing, composition of concessional funds is expected to shift away from grants and towards loans at lower levels of concessionality. Since the country might rely more on loans with commercial terms as it graduates from the low-income status, it will be necessary for the authorities to strengthen fiscal management, upgrade debt and cash management capacity, and scale upwards the country's public investment management capacity.*

[1] This DSA has been prepared by IMF and World Bank staffs, in consultation with 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 3.34 over the past 3 years. Since its average CPIA index has been above 3.25 for two years in a row, Lao P.D.R.'s policy performance remains classified as medium according to the "Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-income Countries" (www.imf.org/external/np/pp/eng/2010/012210.pdf). Therefore, the relevant indicative thresholds for this category are: 40 percent for the PV of debt-to-GDP ratio, 150 percent for the PV of debt-to-exports ratio, 250 percent for the PV of debt-to-revenue ratio, 20 percent for the debt service-to-exports ratio, and 20 percent for the debt service-to-revenue ratio. These thresholds are applicable to public and publicly guaranteed external debt.

BACKGROUND

1. **The 2012 Debt Sustainability Analysis (DSA) reclassified Lao P.D.R.'s risk of debt distress from high to moderate.**[3] This change was mainly driven by the enhancement in Lao P.D.R.'s Country Policy and Institutional Assessment (CPIA) index, which raised the indicative debt distress thresholds significantly while the debt dynamics remained largely unchanged from the 2011 DSA.

2. **This LIC DSA for Lao P.D.R. continues to classify the risk of debt distress as moderate.** Lao P.D.R.'s CPIA index continued to improve slightly in 2012, thus the classification of its policy performance stays moderate and the indicative debt distress thresholds remain the same as in the 2012 DSA. All external debt distress indicators stay below policy-dependent indicative thresholds during the projection period under baseline assumptions.

Lao P.D.R.: External Public Debt Indicators and End-2012

	Indicative thresholds	End-2012
Present value of debt, as a percent of		
GDP	40	32.5
Exports	150	73.8
Revenue	250	184.9
Debt service, as a percent of:		
Exports	20	4.1
Revenue	20	10.1

Sources: Lao P.D.R. authorities; and IMF and World Bank staff estimates

3. **Lao P.D.R.'s external public and publically-guaranteed(PPG) debt remains elevated compared to other LICs in Asia, and the debt level has been rising since 2012.** The nominal stock of external PPG debt increased from US$3.7 billion in 2011 to US$4.2 billion in 2012, mainly due to rapid increase in borrowing from China and Thailand. As a result, even with high real GDP growth and the kip's appreciation vis-à-vis the U.S. dollar, the PPG external debt-to-GDP ratio climbed from 44.8 percent of GDP to 46.1 percent of GDP in 2012. The corresponding net present value (PV) of debt at end-2012 was 32.5 percent of GDP, up from 29.8 percent of GDP in 2011.

4. **The high level of concessionality of official borrowing helps keep the external debt service ratios at manageable levels**, with public and publicly-guaranteed (PPG) external debt stock indicators expected to remain below the policy-dependent indicative thresholds throughout the entire projection period under the baseline scenario. However, the PV of debt to GDP ratio is very close to its safety threshold in the near term. Shocks to the domestic and external environment or excessively loose macroeconomic policies could easily push the stock of external public debt beyond sustainable levels, with some debt distress indicators breaching their respective thresholds under certain stress tests.[4] In this regard, debt dynamics are most sensitive to large depreciation of the kip relatively to baseline in 2014, as external debt is predominantly denominated in foreign currency.

[3] See the joint IMF-WB DSA for 2012: IMF Country Report No.12/286.

[4] Stress tests include sharp exchange rate depreciation, more adverse terms of additional foreign financing, and reductions in GDP growth among others shocks.

5. External PPG debt is split almost evenly between multilateral and bilateral creditors in 2012. The multilateral creditors consist mainly of the Asian Development Bank (AsDB—26 percent of total external debt) and the International Development Association (IDA—14.8 percent of total external debt). Bilateral creditors, mainly China, India, Japan, Korea, Malaysia, Russia, and Thailand account for 47 percent of total external debt. The importance of bilateral creditors has increased significantly vis-à-vis multilateral creditors. Although small, the share of nonconcessional external PPG debt has increased steadily in the last several years, standing at 6.7 percent in 2012. This increase resulted from heavy investments in hydropower and electricity generation projects, including the need by the public sector to finance its equity stakes in these investment projects.

Lao P.D.R.: Stock of Public and Publicly Gauranteed External Debt at End-2012

	In Bllions of U.S. Dollar	As a Share of Total External Debt	In Percent of GDP
Total	4.2	100	46.0
Multilateral	1.9	45.9	21.1
Bilateral	2.0	47.3	21.8
Commercial 1/	0.3	6.7	3.1

Sources: Lao P.D.R authorities; and IMF and World Bank staff estimates

1/ Includes direct borrowing by state-owned enterprises on nonconcessional terms

6. The rising external debt to GDP ratio underscores the need to strengthen debt management capacity. It is particularly important to ensure that debt sustainability considerations are taken into account when new debt is contracted, especially given that the country will rely more on external loans with market terms as it is graduating from low income status. Additional external borrowing to finance infrastructure mega-projects, for example, could easily push the debt-to-GDP ratio over the indicative debt stress threshold, potentially jeopardizing debt sustainability. A mitigating factor for Lao P.D.R.'s external debt burden lies in the prospective returns on the hydropower and mining projects that have been financed in part by external PPG debt. The long-term power purchase agreements that are signed for these projects and the resulting government revenues in the form of royalties, dividends, and profit tax payments arguably reduce the risk of debt distress in the long run. However, many of these projects face construction and implementation challenges, and will not generate significant return in the near term.

7. Recorded domestic public debt rose to 15.8 percent of GDP in 2012, up from 8.9 percent of GDP in 2011. The Bank of the Lao P.D.R. (BoL) continued to disburse loans to finance local government's off-budget infrastructure projects. Lending from the BOL to local governments represents about half of the recorded total domestic debt, with the remainder including government bonds related to the recapitalization of state-owned commercial banks (SOCBs). Total domestic and external PPG debt stood at 61.8 percent of GDP in 2012, up from 56.2 percent the year before. This increase is related to a more expansionary fiscal policy in 2012 including central government financing of large public investment projects. The stock of BOL loans to local governments is projected to peak in the near future as these quasi-fiscal operations are phased out.

ASSUMPTIONS UNDERLYING THE DEBT SUSTAINABILITY ANALYSIS

8. The medium-term macroeconomic framework underlying the DSA is summarized in Box 1. The baseline scenario—which is based on current policies—projects annual average real growth of 6.9 percent between 2013 and 2033. Real GDP growth is projected to rise to 8.2 percent in 2013 before reverting toward potential of about 7½ percent in the medium term. With economic activity expanding beyond potential and a further increase in public employee payrolls in 2013–15, price pressures are expected to increase. Consumer price inflation is projected to be around 7 percent on average in the medium term.

Lao P.D.R.: Macroeconomic Assumption: Comparison with 2012
(Average over the 20 years projection horizon)

	2012 DSA	2013 DSA
GDP growth	6.8	6.9
GDP deflator in U.S. dollar terms (in percent)	2.1	2.2
Non interest current account deficit	12.2	12.3
Primary deficit	0.7	1.6

Sources: Lao P.D.R authorities; and IMF and World Bank staff estimates

9. However, the baseline projects significant deterioration in medium-term external and fiscal position compared to the 2012 DSA. Due to the surge of imports and weaker export growth momentum in 2012, the current account deficit widened significantly to 28.4 percent of GDP from 15.5 percent of GDP in 2011, and is expected to further deteriorate to 29.5 percent of GDP in 2013. The fiscal position in FY2012/13 also deteriorated significantly due to high financing of off-budget public investment projects and public sector compensation increase. Over the long run, the baseline path of the fiscal positions has worsened compared to the 2012 DSA due to continued expansionary fiscal policy.

10. As a result, a higher level of external financing is assumed. To meet the country's financing needs, higher level of new borrowing is projected. This is consistent with the authorities' disbursement projection over 2013-2018. The external financing is assumed to remain largely on concessional terms over the medium term. In the long run, as Lao P.D.R. graduates from low-income country status, grant financing is expected to decline relative to loans from bilateral creditors as well as from commercial sources, and thus the share of commercial external PPG debt is projected to rise over the long term. It is worth noting that as the domestic financial market deepens, the private sector will be able to rely more on domestic financing, lowering the needs for foreign borrowing. This would bring down the share of external private debt in total external debt, which, along with declining overall external debt stock in percent of GDP, would reduce the contribution from nominal interest rate in the longer run.

DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

11. The PV of the external debt-to-GDP ratio remains below the policy-dependent indicative thresholds during the projection period under baseline conditions (Figure 1 and Table 1), **but is much**

higher than in previous DSA and is very close to the thresholds in the near term. This change is driven by the higher debt stock at end-2012, as well as projected higher new borrowing because Lao P.D.R.'s current account deficit is expected to narrow only gradually over the projection period. Similar to last year's DSA, all three external debt stock indicators are projected to remain more or less flat until about 2018, as large projected disbursements are expected to be counteracted by a combination of debt repayment and high GDP growth during the next several years. In line with the previous DSA, debt service ratios under the baseline scenario are projected to fall below policy-dependent thresholds during the projection period.

12. Exchange rate movements and shocks to the cost of new loans present the most important risks to external debt sustainability. Table 3 and Figure 1 illustrate how a one-off 30 percent depreciation of the kip vis-à-vis the U.S. dollar would lead to a sharp rise in the PV of debt-to-GDP and the PV of debt-to-revenues. In both cases the policy-dependent thresholds are breached. A rise in the cost of additional financing (by 200 basis points relative to the baseline) would increase the PV of debt-to-exports ratio by around 29 percentage points in the long run relative to the baseline. However, even under this extreme scenario, there would be no breaches of the corresponding threshold.

13. Debt dynamics continue to be markedly worse under an alternative scenario in which key variables are either set at their historical averages or subject to shocks, such as one-time exchange rate depreciation and a temporary decline in FDI inflows. Through 2016, debt dynamics are more favorable under this historical scenario—which takes into account the appreciation of the kip relative to the U.S. dollar experienced during 2003–2012.[5] In later years, however, this effect is outweighed by the higher historical average of the current account deficit (16 percent of GDP compared to 9.4 percent of GDP in the baseline), and the lower historical average for FDI (5.1 percent of GDP compared to 9.3 percent of GDP in the baseline). The historical scenario thus assumes around 9 percentage points of GDP more in debt accumulation than the baseline, putting Lao P.D.R. on an unsustainable path in the long run. Therefore, a negative shock to FDI in Lao P.D.R. would force it to reduce substantially its current account deficit in order to avoid external debt distress.

14. An illustrative scenario involving a high-speed railway megaproject linking Lao P.D.R. and China shows that the country's debt sustainability indicators would breach their indicative policy-dependent thresholds. Under this scenario: (1) the additional external borrowing amounts to US$ 6.7 billion over 5 years (adding to US$ 1.34 billion per annum), starting in 2014; (2) the financing terms are: 2 percent fixed rate debt, with 20-year maturity, 10-year grace period, and loan denominated in USD; and (3) a fiscal multiplier of 0.5 during the construction period.[6] As a result, the overall external PPG debt would peak at around 80 percent of GDP in 2022, and exceed 60 percent of GDP for the next decade, while the total external debt would surpass 125 percent of GDP in 2014, and remain above the 100 percent mark for the next decade. Also, the ratio of debt service to revenue exceeds the 20 percent threshold in 2021 and remains elevated for the entire projection period.

[5] The kip appreciated 2.4 percent per year on average during this period.

[6] This value is an upper bound given a heavy reliance on imported inputs.

Box 1. Baseline Scenario—Underlying Assumptions (2012–32)

The baseline macroeconomic framework assumes that the economy is overheating due to expansionary fiscal and monetary policies. Although long-term growth is still anchored by the vigorous energy production sector, vulnerabilities have heightened.

Real GDP growth is projected to average 7.8 percent during 2013–18. The near-term outlook is spurred by the fiscal expansion, real GDP growth is projected to rise to 8.2 percent in 2013 before reverting toward potential of about 7½ percent in the medium term. This outlook depends on continued accommodative monetary policy, rising public sector employee compensation, vigorous resource-related FDI inflows, rising electricity demand from neighboring countries, and a gradual pickup of investment inflows into nonresource sectors following Lao P.D.R.'s recent WTO accession. Over the longer term, assumed structural reforms would create a better environment for private investment, broadening the sources of growth. Real GDP is expected to moderate to 6.7 percent on average during 2019–33, as production in the resource sector reaches maturity. Over time, the share of agriculture in GDP is expected to decline, as the transition to a market based economy is accompanied by the rising importance of the industry and services sectors. Graduation from low-income status could be achieved in the second half of the projection period.

Inflation is projected to average about 6.5 percent in 2013, and reaches 7.5 percent in 2014. With economic activity expanding beyond potential and a further increase in public employee payrolls in 2013–15, price pressures are expected to increase. Over the medium term, inflation is expected to decline further, but it is projected to remain above 5 percent until 2018.

The balance of payments continues to be driven by developments in the resource sector, which has an important bearing both in the current account and the capital and financial account. The current account deficit is expected to widen to about 29.5 percent of GDP in 2013–14, as the nonresource deficit remains elevated and the resource deficit temporarily increases before large-scale power projects come on stream in 2015–2016. FDI inflows are assumed to be vigorous over the next two years, driven by growing investment inflows into both resource and nonresource sectors following Lao P.D.R.'s recent WTO accession. However, reserve levels would be inadequate by low-income country (LIC) metrics at less than 1½ months of imports. The current account is projected to improve over medium and long term, assuming that nonresource exports and services will gradually pick up driven by solid recovery in advanced economies, strengthened regional integration, supported by improvements in the investment climate, streamlining of business regulations, and the prevalence of trade commitments.

External financing is assumed to remain on largely concessional terms over the medium term. In the long-run, however, grant financing decreases with economic development.

- **Multilateral creditors:** Projected loan disbursements in the medium term are relatively low, since IDA and AsDB have a pipeline of operations financed on grant terms. Over the longer term, project loans are assumed to increase moderately.

- **Bilateral creditors:** For 2013–18, project loan disbursements also increase, as donors provide support to the government's development agenda. Over the medium and longer term, greater participation by new emerging market creditors results in an increased role for bilateral finance, including for lending to state-owned enterprises.

- **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 the new hydropower projects. In addition, the initiative of bond issuance in Thailand market is incorporated in the DSA assumptions. A 50-million USD bond was issued in 2013, and two 100-million USD bond issuances are being planned for 2014 and 2015. The share of commercial loans in total PPG external debt has risen in 2012, and is expected to continue rising over the long term as the country becomes more market-based.

Fiscal policy is projected to be expansionary in the near term, and then shift back to the consolidation path. The primary deficit is projected to peak at 4.3 percent of GDP in 2013, up from 1.7 percent of GDP in 2012, then decline gradually to around 1.3 percent of GDP in 2018. Over the long-term the primary deficit is expected to stabilize at around 2 percent as improvements in nonmining revenue collection are counteracted by declines in mining and resource related revenue, while expenditure remains constant as a percent of GDP.

Domestic debt decreases over the medium term driven by repayments of the lending to local governments from the BOL. In the long term, net external finance declines relative to GDP, and a larger share of budget deficits is financed domestically, pushing domestic debt to higher but sustainable levels.

B. Public Sector Debt Sustainability

15. In line with the previous DSA's projections, the PV of total PPG debt in percent of GDP and in percent of revenue are both projected to decline markedly over the long run under baseline assumptions (Figure 2 and Table 2). Domestic debt is expected to peak at 17.3 percent of GDP in 2016, rising from 15.8 percent of GDP in 2012. This is driven by the worsening fiscal position related to large increases in public employee remuneration. Domestic debt is projected to decline starting in 2017. Accordingly, the PV of debt-to-revenue ratio is also projected to decline starting in 2017, as revenue administration reforms take hold and expenditure control is maintained after the large increases in public employee remuneration.

16. Public debt ratios are particularly sensitive to a depreciation of the kip over the medium term (Figure 2 and Table 4). Similar to the results in last year's DSA, a 30 percent depreciation of the kip against the US dollar in 2014 would immediately raise the PV of public debt-to-GDP and the PV of public debt-to-revenue. While the debt service-to-revenue ratio is relatively stable under the baseline scenario, it would increase permanently by a substantial margin if the kip were to depreciate sharply. It should be noted that this scenario is likely to overstate risks given that a significant share of GDP, including most of the natural resource GDP, is earned in foreign currency.

17. The debt ratios are also sensitive to the realization of contingent liabilities. Public investment projects at the local government level could become liabilities of the central government if projects to do not perform as expected. While the baseline scenario assumes that the BOL will phase out its quasi-fiscal lending completely by 2014, there is a risk that these operations could continue.

18. Alternative scenarios show less positive debt dynamics over the longer term, which highlights the importance of fiscal consolidation over time. In the historical scenario, where real GDP growth and the primary balance are at their historical average, the PV of public debt-to-GDP ratio rises above 39 percent by 2033, while under the baseline, the ratio of the PV of public debt to GDP remains at around 30 percent in 2033. This is because the projected primary deficit in the baseline is lower (1.9 percent of GDP in baseline compared to 2.9 percent of GDP in the historical scenario). If the primary balance is fixed at the level projected for 2013, the PV of debt-to-GDP would be much higher than the baseline in the long term (55.6 at 2033).

THE AUTHORITIES' VIEWS

19. The authorities broadly agreed with the overall assessment but emphasized that the debt service ability should be more important in measuring debt sustainability. They expect better access to official financial resources which will improve their ability to finance capital needs. On the basis of information provided by local contracting parties, the authorities anticipated an increase in disbursements of new funds from some bilateral donors between 2013 and 2018 which has been incorporated into this

DSA.[7] Since Lao P.D.R. is expected to rely more on commercial funds as it graduates from its low-income country status, the authorities expect better access to nonconcessional loans in the future, and attach great importance to fiscal consolidation..

20. The authorities highlighted that an important part of the external debt is related to viable large projects in the resource sectors. They believe that resource-related projects will generate high and stable economic returns upon completion. In addition, the relatively long maturity profile of the loans would help mitigate the risks of debt distress. Finally, new borrowing to implement large-scale infrastructure projects is expected to be made without unduly raising debt sustainability concerns.

CONCLUSION

21. Although the Lao P.D.R.'s risk of debt distress remains moderate, the PV of external PPG debt to GDP ratio comes very close to the policy-dependent indicative thresholds in the near term. While the thresholds are not breached by any of the debt distress indicators under baseline scenario, the PV of debt to GDP ratio approaches the threshold in the near term, driven by the rising debt stock at end-2012 as well as higher projected new borrowing in the future due to the expansionary fiscal path, leading to higher domestic and external financing needs. The buffers in case of any adverse shock are very limited.

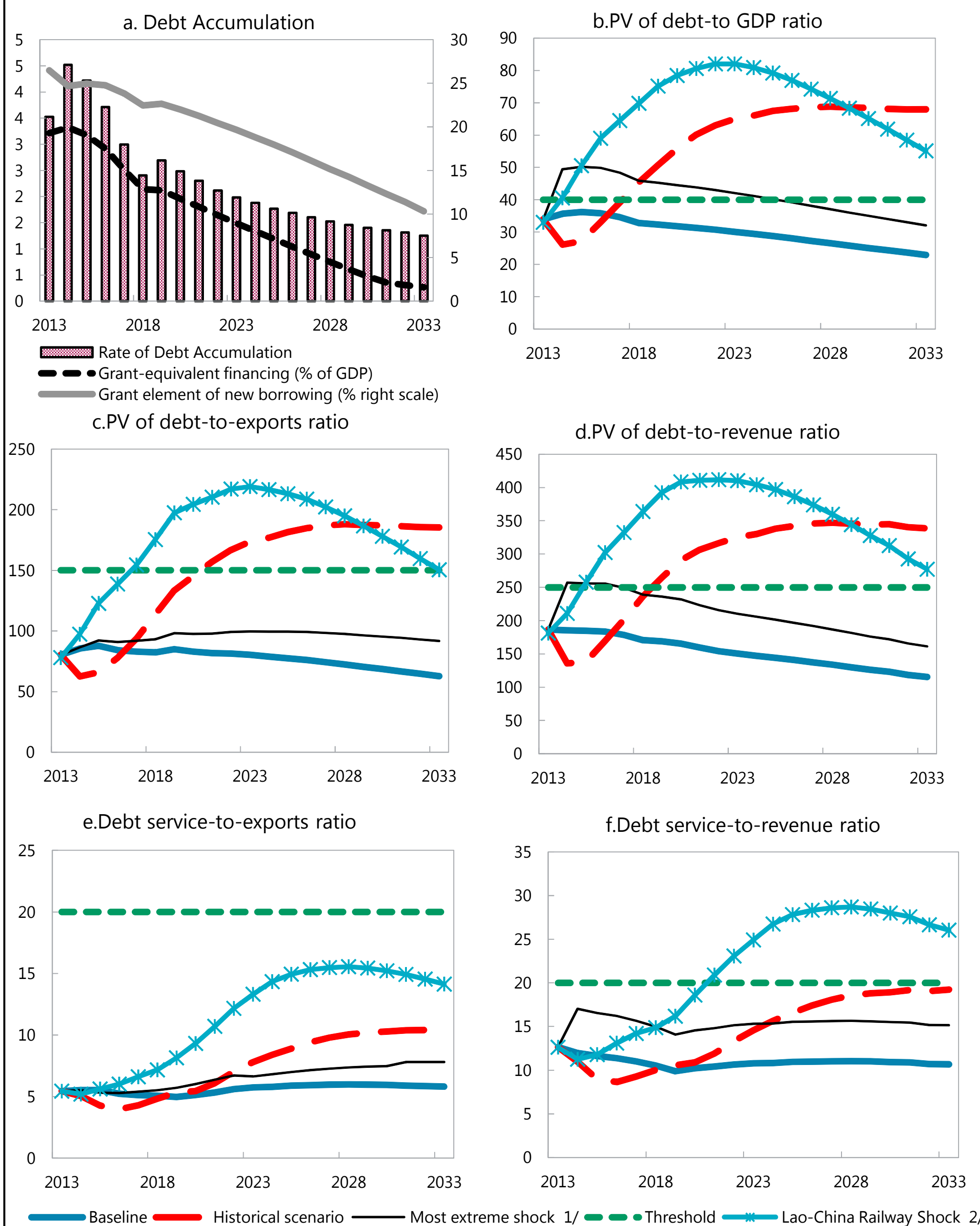
22. Moreover, these results are still sensitive to assumptions regarding investment and performance of the resource sector, as well as large swings in the exchange rate. The debt dynamics reflect current and planned large-scale investments in hydropower and mining projects that will only deliver returns over the medium term. Despite long-term contracts with fixed prices for energy exports to neighboring countries, Lao P.D.R.'s economy remains exposed in the medium term to fluctuations in copper and gold prices, as well as to economic developments in its main trading partners (China, Thailand and Vietnam).[8] Lower growth in Lao P.D.R. a weaker balance of payments, and sharp depreciation of the kip would worsen debt dynamics significantly. Thus, there is a need to tighten macroeconomic-fiscal policies to support external debt sustainability. Fiscal policy needs to be put back on a consolidation path during the next few years. Cautious assessment and monitoring of large-scale projects and private external debt will be required to mitigate the risks posed to external and public debt sustainability, especially if some of these projects are financed from commercial sources, such as bonds backed by future revenues.

[7] The staff assumes the US$961 million of projected disbursements from China between 2013–2018, which is based on information provided by the authorities. These disbursements are much larger than the 2012 DSA assumptions ($600 million). Coupled with higher borrowing projection from Thailand, it results in a higher PV of debt to GDP ratio. However, the debt distress indicators under baseline remain below their policy-dependent thresholds, and thus there is no material change in the overall assessment of debt distress.

[8] In a customized scenario where commodity prices decline by 10 percent in 2013 and 2014, debt stock indicators breach their policy-dependent thresholds, illustrating the vulnerability of Lao P.D.R. to commodity price shocks. However, this customized scenario poses less of a threat to debt dynamics than the historical scenario.

23. To remain sustainable, external borrowing should mostly be obtained on concessional terms and fiscal and quasi-fiscal liabilities should be carefully managed with a view to establishing buffers against vulnerabilities. Prudent debt management, cash management, as well as cautious assessment and monitory of large-scale projects, will be required to mitigate the potential risks of adverse debt dynamics under stress scenarios. Fiscal risk could arise if these projects fail to generate the expected returns, including to the government's own equity stakes. In this light, enhancing the government's public investment management capacity will go a long way toward increasing the benefits derived from debt-financed public investments.

Figure 1. Lao P.D.R.: Indicators of Public and Publicity Guaranteed External Debt Under Alternatives Scenarios, 2013–2033

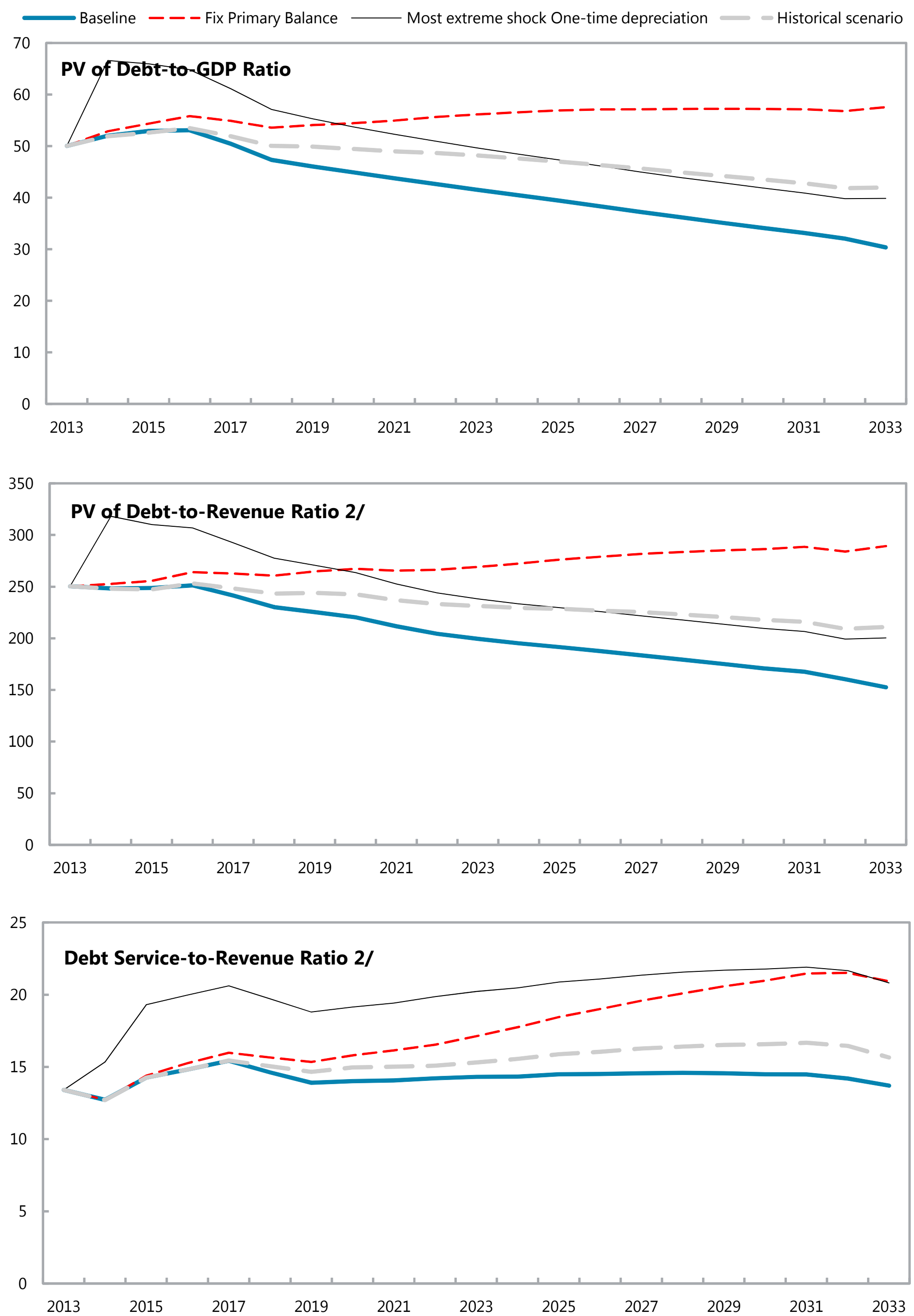


Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2023. In figure b. it corresponds to a one-time nominal depreciation shock; in c. to a terms shock; in d. to a one-time nominal depreciation shock; in e. to a terms shock and in figure f. to a one-time nominal depreciation shock

2/The Lao-China railway senario assums (1) the additional external borrowing amounts to US$ 6.7 billion over 5 years (adding to US$ 1.34 billion per annum), starting in 2014; (2) the financing terms are as follows: 2 percent fixed rate debt, with 20-year maturity, 10-year grace period, and loan denominated in USD; and (3) a fiscal multiplier of 0.5

Figure 2. Lao P.D.R.: Indicators of Public Debt Under Alternative Scenarios, 2013–2033 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2023.
2/ Revenues are defined inclusive of grants.

Table 1. Lao P.D.R.: External Debt Sustainability Framework, Baseline Scenario, 2010–2033 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 2/	Standard Deviation 2/	Projections									
	2010	2011	2012			2013	2014	2015	2016	2017	2018	2013–2018 Average	2023	2033	2019–2033 Average
External debt (nominal) 1/	**88.1**	**84.1**	**89.9**			**109.1**	**125.7**	**131.5**	**125.7**	**119.5**	**112.4**		**84.7**	**47.1**	
of which: public and publicly guaranteed (PPG)	50.3	44.8	46.1			47.4	49.1	49.2	48.3	46.1	43.2		38.1	27.6	
Change in external debt	-14.3	-4.0	5.8			19.2	16.6	5.8	-5.8	-6.2	-7.2		-2.8	-3.8	
Identified net debt-creating flows	-10.5	-6.0	13.0			16.0	14.0	3.8	-3.3	-4.4	-5.8		-2.5	-3.7	
Non-interest current account deficit	**16.3**	**13.8**	**26.8**	**16.0**	**4.9**	**27.9**	**25.5**	**21.8**	**15.9**	**13.8**	**14.2**		**10.8**	**5.1**	9.1
Deficit in balance of goods and services	14.7	13.7	27.7			29.5	27.7	24.0	18.8	16.7	17.2		13.1	7.8	
Exports	39.9	45.5	44.0			42.3	41.7	41.2	42.5	41.7	39.8		37.4	36.6	
Imports	54.6	59.2	71.7			71.8	69.4	65.1	61.3	58.4	57.0		50.5	44.4	
Net current transfers (negative = inflow)	-2.6	-2.6	-2.7	-2.7	0.4	-2.7	-2.7	-2.7	-2.7	-2.6	-2.5		-2.1	-2.3	-2.1
of which: official	-1.6	-1.6	-1.6			-1.6	-1.6	-1.6	-1.6	-1.5	-1.4		-0.9	0.0	
Other current account flows (negative = net inflow)	4.3	2.7	1.8			1.1	0.5	0.6	-0.2	-0.3	-0.5		-0.2	-0.3	
Net FDI (negative = inflow)	**-9.9**	**-7.1**	**-6.2**	**-5.1**	**3.4**	**-6.7**	**-5.8**	**-11.0**	**-13.3**	**-12.7**	**-14.6**		**-10.1**	**-6.8**	-9.3
Endogenous debt dynamics 3/	**-16.9**	**-12.8**	**-7.6**			**-5.2**	**-5.7**	**-7.0**	**-5.9**	**-5.5**	**-5.5**		**-3.3**	**-2.0**	
Contribution from nominal interest rate	1.9	1.4	1.6			1.6	1.8	1.9	3.6	3.2	2.9		2.1	1.1	
Contribution from real GDP growth	-6.8	-5.9	-5.9			-6.8	-7.5	-8.9	-9.5	-8.6	-8.3		-5.3	-3.0	
Contribution from price and exchange rate changes	-12.0	-8.2	-3.3			...	...	...	...	...	...		...	...	
Residual (3-4) 4/	**-3.9**	**2.0**	**-7.2**			**3.2**	**2.6**	**2.0**	**-2.5**	**-1.8**	**-1.3**		**-0.3**	**-0.1**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 5/	...	...	76.3			95.6	112.3	118.5	113.3	108.0	101.9		76.7	42.5	
In percent of exports	...	...	173.4			226.1	269.4	287.9	266.3	258.8	256.0		204.9	116.1	
PV of PPG external debt	**...**	**...**	**32.5**			**33.9**	**35.7**	**36.2**	**35.8**	**34.6**	**32.8**		**30.1**	**23.0**	
In percent of exports	**...**	**...**	**73.8**			**80.3**	**85.6**	**87.9**	**84.2**	**83.0**	**82.3**		**80.4**	**62.7**	
In percent of government revenues	**...**	**...**	**184.9**			**186.4**	**185.4**	**184.6**	**183.6**	**178.4**	**170.8**		**150.5**	**115.5**	
Debt service-to-exports ratio (in percent)	**80.9**	**53.9**	**52.2**			**70.7**	**69.8**	**62.3**	**104.5**	**109.2**	**109.3**		**76.7**	**42.5**	
PPG debt service-to-exports ratio (in percent)	**4.4**	**2.7**	**4.1**			**5.4**	**5.5**	**5.5**	**5.2**	**5.1**	**5.1**		**5.8**	**5.8**	
PPG debt service-to-revenue ratio (in percent)	**11.0**	**7.5**	**10.1**			**12.6**	**12.0**	**11.6**	**11.4**	**11.0**	**10.5**		**10.8**	**10.7**	
Total gross financing need (Billions of U.S. dollars)	2.7	2.6	4.0			5.1	5.3	4.3	6.2	6.9	7.2		7.7	8.2	
Non-interest current account deficit that stabilizes debt ratio	30.7	17.8	21.0			8.7	8.9	16.0	21.7	20.0	21.4		13.6	8.9	
Key macroeconomic assumptions															
Real GDP growth (in percent)	8.1	8.0	7.9	7.6	0.7	8.2	7.5	7.8	8.0	7.7	7.9	7.8	6.6	6.5	6.7
GDP deflator in US dollar terms (change in percent)	13.3	10.2	4.1	9.8	6.1	0.8	0.6	2.5	2.9	3.8	4.6	2.5	2.0	2.0	2.0
Effective interest rate (percent) 6/	2.3	1.8	2.1	1.8	0.3	1.9	1.8	1.7	3.0	2.8	2.7	2.3	2.6	2.3	2.5
Growth of exports of G&S (US dollar terms, in percent)	42.7	35.7	8.7	22.3	17.7	4.8	6.5	9.1	14.9	9.7	7.6	8.8	7.8	8.7	8.2
Growth of imports of G&S (US dollar terms, in percent)	26.4	29.2	36.0	24.5	11.3	9.2	4.5	3.6	4.7	6.5	10.1	6.4	7.1	7.4	7.0
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	26.5	24.7	25.0	24.8	23.8	22.5	24.5	19.6	10.3	16.8
Government revenues (excluding grants, in percent of GDP)	15.8	16.4	17.6			18.2	19.2	19.6	19.5	19.4	19.2		20.0	19.9	19.8
Aid flows (in Billions of US dollars) 7/	0.2	0.2	0.2			0.3	0.4	0.4	0.4	0.4	0.4		0.5	0.3	
of which: Grants	0.2	0.2	0.2			0.2	0.2	0.2	0.2	0.2	0.2		0.2	0.0	
of which: Concessional loans	0.0	0.0	0.0			0.1	0.2	0.2	0.2	0.2	0.2		0.2	0.3	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			3.2	3.3	3.2	2.9	2.5	2.1		1.5	0.3	1.1
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			44.7	40.2	41.2	42.3	43.6	44.8		36.5	10.8	28.0
Memorandum items:															
Nominal GDP (Billions of US dollars)	6.9	8.2	9.2			10.0	10.8	11.9	13.3	14.8	16.7		26.0	59.5	
Nominal dollar GDP growth	22.5	19.1	12.3			9.1	8.1	10.4	11.2	11.8	12.8	10.6	8.8	8.6	8.8
PV of PPG external debt (in Billions of US dollars)			3.0			3.3	3.8	4.2	4.7	5.1	5.4		7.7	13.5	
(PVt-PVt-1)/GDPt-1 (in percent)						3.5	4.5	4.2	3.7	3.0	2.4	3.6	2.0	1.3	1.8
Gross workers' remittances (Billions of US dollars)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of PPG external debt (in percent of GDP + remittances)	...	...	32.5			33.9	35.7	36.2	35.8	34.6	32.8		30.1	23.0	
PV of PPG external debt (in percent of exports + remittances)	...	...	73.8			80.3	85.6	87.9	84.2	83.0	82.3		80.4	62.7	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	4.1			5.4	5.5	5.5	5.2	5.1	5.1		5.8	5.8	

Sources: Country authorities; and staff estimates and projections.
1/ Includes both public and private sector external debt.
2/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.
3/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) 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, 2010–2033

(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2010	2011	2012	Average 1/	Standard Deviation 1/	2013	2014	2015	2016	2017	2018	2013–18 Average	2023	2033	2019–33 Average
Public sector debt 2/	59.1	56.2	61.8			63.5	65.4	66.0	65.5	62.0	57.8		49.6	35.0	
of which: foreign-currency denominated	50.3	44.8	46.1			47.4	49.1	49.2	48.3	46.1	43.2		38.1	27.6	
Change in public sector debt	-4.9	-3.0	5.7			1.7	1.9	0.5	-0.4	-3.5	-4.2		-1.5	-2.0	
Identified debt-creating flows	-8.2	-5.6	-3.5			1.1	-1.3	-1.9	-3.3	-4.2	-4.5		-1.5	-0.4	
Primary deficit	3.7	2.2	1.7	2.9	1.1	4.3	3.0	3.4	2.3	1.5	1.1	2.6	1.1	1.3	1.2
Revenue and grants	18.1	18.6	19.6			20.0	20.9	21.3	21.1	20.9	20.6		20.9	19.9	
of which: grants	2.3	2.2	2.1			1.8	1.7	1.7	1.6	1.5	1.4		0.9	0.0	
Primary (noninterest) expenditure	21.8	20.8	21.3			24.3	23.9	24.7	23.4	22.4	21.7		21.9	21.2	
Automatic debt dynamics	-11.8	-7.8	-5.2			-3.2	-4.3	-5.3	-5.6	-5.6	-5.6		-2.6	-1.7	
Contribution from interest rate/growth differential	-5.2	-5.2	-4.1			-4.6	-4.7	-4.8	-4.8	-4.5	-4.3		-2.5	-1.6	
of which: contribution from average real interest rate	-0.3	-0.8	0.0			0.1	-0.3	-0.1	0.0	0.2	0.2		0.7	0.6	
of which: contribution from real GDP growth	-4.8	-4.4	-4.1			-4.7	-4.4	-4.7	-4.9	-4.7	-4.5		-3.2	-2.2	
Contribution from real exchange rate depreciation	-6.7	-2.6	-1.1			1.4	0.3	-0.5	-0.7	-1.2	-1.3		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			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	3.3	2.6	9.2			0.6	3.3	2.4	2.9	0.6	0.3		0.0	-1.6	
Other Sustainability Indicators															
PV of public sector debt	...	...	48.3			50.0	52.0	52.9	53.1	50.5	47.3		41.6	30.4	
of which: foreign-currency denominated	...	...	32.5			33.9	35.7	36.2	35.8	34.6	32.8		30.1	23.0	
of which: external	...	...	32.5			33.9	35.7	36.2	35.8	34.6	32.8		30.1	23.0	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 3/	6.8	4.7	6.7			14.2	11.6	11.1	11.0	9.5	9.1		7.4	6.3	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	245.8			250.3	248.4	248.9	251.4	241.6	230.1		199.4	152.6	
PV of public sector debt-to-revenue ratio (in percent)	...	...	274.6			274.8	270.4	270.1	272.0	260.2	246.6		208.0	152.7	
of which: external 4/	...	...	184.9			186.4	185.4	184.6	183.6	178.4	170.8		150.5	115.5	
Debt service-to-revenue and grants ratio (in percent) 5/	10.3	7.2	10.3			13.4	12.7	14.3	14.8	15.4	14.6		14.3	13.2	
Debt service-to-revenue ratio (in percent) 5/	11.8	8.2	11.5			14.7	13.8	15.5	16.0	16.6	15.7		14.9	13.2	
Primary deficit that stabilizes the debt-to-GDP ratio	8.6	5.2	-4.0			2.6	1.1	2.9	2.7	5.0	5.3		2.6	3.3	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	8.1	8.0	7.9	7.6	0.7	8.2	7.5	7.8	8.0	7.7	7.9	7.8	6.6	6.5	6.7
Average nominal interest rate on forex debt (in percent)	1.4	0.7	1.6	1.0	0.3	1.9	2.0	2.2	2.3	2.4	2.5	2.2	2.8	3.6	3.1
Average real interest rate on domestic debt (in percent)	-7.3	-5.3	-1.4	-0.5	5.8	-1.0	-3.6	-2.5	-1.6	-0.7	-0.8	-1.7	2.5	1.5	2.7
Real exchange rate depreciation (in percent, + indicates depreciation)	-12.9	-5.7	-2.6	-7.1	7.2	3.2	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	9.9	7.1	3.8	7.3	5.4	3.8	6.4	8.1	8.1	8.1	8.1	7.1	5.1	5.1	5.1
Growth of real primary spending (deflated by GDP deflator, in percent)	0.0	0.0	0.1	0.1	0.1	0.2	0.1	0.1	0.0	0.0	0.0	0.1	0.1	0.1	0.1
Grant element of new external borrowing (in percent)	...	...	...	...	...	26.5	24.7	25.0	24.8	23.8	22.5	24.5	19.6	10.3	...

Sources: Country 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/ Public sector debt covers general government gross debt.

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, 2013–2033

(In percent)

	Projections							
	2013	2014	2015	2016	2017	2018	**2023**	2033
PV of debt-to GDP ratio								
Baseline	34	36	36	36	35	33	**30**	23
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013–2033 1/	34	26	27	33	39	45	**65**	68
A2. New public sector loans on less favorable terms in 2013–2033 2/	34	36	38	39	38	37	**37**	34
China Railway Loan	33	41	51	59	64	70	**82**	55
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014–2015	34	35	36	36	34	33	**30**	23
B2. Export value growth at historical average minus one standard deviation in 2014–2015 3/	34	35	38	37	36	34	**31**	23
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014–2015	34	34	34	34	33	31	**28**	22
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014–2015 4/	34	38	47	46	44	42	**36**	25
B5. Combination of B1-B4 using one-half standard deviation shocks	34	32	34	34	33	31	**28**	21
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	34	49	50	50	48	46	**42**	32
PV of debt-to-exports ratio								
Baseline	80	86	88	84	83	82	**80**	63
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013–2033 1/	80	63	66	78	94	114	**174**	185
A2. New public sector loans on less favorable terms in 2013–2033 2/	80	86	92	91	92	93	**100**	92
China Railway Loan	78	97	123	139	154	175	**219**	150
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014–2015	80	83	86	82	81	81	**79**	61
B2. Export value growth at historical average minus one standard deviation in 2014–2015 3/	80	86	98	93	92	92	**88**	67
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014–2015	80	83	86	82	81	81	**79**	61
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014–2015 4/	80	92	114	108	106	105	**96**	67
B5. Combination of B1-B4 using one-half standard deviation shocks	80	77	82	78	77	77	**74**	56
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	80	83	86	82	81	81	**79**	61
PV of debt-to-revenue ratio								
Baseline	186	185	185	184	178	171	**151**	116
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013–2033 1/	186	136	139	170	202	236	**325**	339
A2. New public sector loans on less favorable terms in 2013–2033 2/	186	187	193	198	198	193	**187**	169
China Railway Loan	181	211	258	302	332	364	**410**	277
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014–2015	186	181	182	182	178	170	**150**	115
B2. Export value growth at historical average minus one standard deviation in 2014–2015 3/	186	184	193	192	187	179	**155**	116
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014–2015	186	175	172	172	168	161	**142**	108
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014–2015 4/	186	200	239	235	227	217	**179**	124
B5. Combination of B1-B4 using one-half standard deviation shocks	186	169	173	172	168	161	**140**	105
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	186	257	256	255	249	239	**210**	161

Table 3. Lao P.D.R.: Sensitivity Analaysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2013–2033 (concluded)

(In percent)

	Debt service-to-exports ratio							
Baseline	5	6	6	5	5	5	**6**	6
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013–2033 1/	5	5	4	4	4	5	**8**	10
A2. New public sector loans on less favorable terms in 2013–2033 2/	5	6	5	5	5	6	**7**	8
China Railway Loan	5	5	6	6	7	7	**13**	14
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014–2015	5	6	6	5	5	5	**6**	6
B2. Export value growth at historical average minus one standard deviation in 2014–2015 3/	5	6	6	6	6	6	**6**	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014–2015	5	6	6	5	5	5	**6**	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014–2015 4/	5	6	6	6	6	6	**7**	7
B5. Combination of B1-B4 using one-half standard deviation shocks	5	5	5	5	5	5	**5**	5
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	5	6	6	5	5	5	**6**	6
	Debt service-to-revenue ratio							
Baseline	13	12	12	11	11	11	**11**	11
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013–2033 1/	13	11	9	9	9	10	**15**	19
A2. New public sector loans on less favorable terms in 2013–2033 2/	13	12	11	12	12	11	**12**	14
China Railway Loan	13	11	12	13	14	15	**25**	26
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014–2015	13	12	12	12	11	11	**11**	11
B2. Export value growth at historical average minus one standard deviation in 2014–2015 3/	13	12	12	12	11	11	**11**	11
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014–2015	13	12	11	11	11	10	**10**	10
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014–2015 4/	13	12	12	14	13	12	**14**	12
B5. Combination of B1-B4 using one-half standard deviation shocks	13	11	11	11	10	10	**10**	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	13	17	17	16	16	15	**15**	15
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	17	17	17	17	17	17	**17**	17

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt 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 2013–2033

		Projections						
	2013	2014	2015	2016	2017	2018	2023	2033
PV of Debt-to-GDP Ratio								
Baseline	50	52	53	53	50	47	42	30
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	50	52	53	54	52	50	48	42
A2. Primary balance is unchanged from 2013	50	53	54	56	55	54	56	58
A3. Permanently lower GDP growth 1/	50	52	53	53	51	48	43	36
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014–2015	50	52	54	54	52	49	44	35
B2. Primary balance is at historical average minus one standard deviations in 2014–2015	50	53	54	54	51	48	42	32
B3. Combination of B1-B2 using one half standard deviation shocks	50	52	54	54	51	48	43	34
B4. One-time 30 percent real depreciation in 2014	50	67	66	65	61	57	50	40
B5. 10 percent of GDP increase in other debt-creating flows in 2014	50	59	59	59	56	52	45	34
PV of Debt-to-Revenue Ratio 2/								
Baseline	250	248	249	251	242	230	199	153
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	250	248	247	253	248	243	231	211
A2. Primary balance is unchanged from 2013	250	253	256	264	263	261	269	289
A3. Permanently lower GDP growth 1/	250	249	250	253	244	233	207	182
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014–2015	250	250	254	257	248	237	209	176
B2. Primary balance is at historical average minus one standard deviations in 2014–2015	250	252	254	256	246	234	203	163
B3. Combination of B1-B2 using one half standard deviation shocks	250	251	252	255	246	235	205	170
B4. One-time 30 percent real depreciation in 2014	250	318	310	307	293	278	238	200
B5. 10 percent of GDP increase in other debt-creating flows in 2014	250	281	279	280	268	255	218	172
Debt Service-to-Revenue Ratio 2/								
Baseline	13	13	14	15	15	15	14	13
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	13	13	14	15	15	15	15	16
A2. Primary balance is unchanged from 2013	13	13	14	15	16	16	17	21
A3. Permanently lower GDP growth 1/	13	13	14	15	16	15	15	14
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014–2015	13	13	14	15	16	15	15	14
B2. Primary balance is at historical average minus one standard deviations in 2014–2015	13	13	14	15	16	15	15	13
B3. Combination of B1-B2 using one half standard deviation shocks	13	13	14	15	16	15	15	14
B4. One-time 30 percent real depreciation in 2014	13	15	19	20	21	20	20	21
B5. 10 percent of GDP increase in other debt-creating flows in 2014	13	13	15	18	16	15	16	14

Sources: Country 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 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

October 31, 2013

Prepared By | Asia and Pacific Department (In consultation with other Departments)

CONTENTS

FUND RELATIONS

(As of September 30, 2013)

Membership Status: Joined on July 5, 1961.

General Resources Account:

	SDR Million	Percent Quota
Quota	52.9	100.0
Fund holdings of currency (Exchange Rate)	52.9	100.0
Reserve Tranche Position	0.0	0.0

SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	50.68	100.00
Holdings	51.07	100.78

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved	Amount Drawn
ECF[1]	04/25/2001	04/24/2005	31.70	18.12
ECF[1]	06/04/1993	05/07/1997	35.19	35.19
SAF	09/18/1989	09/17/1992	20.51	20.51

Projected Payments to the Fund[2]
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/Interest		0.00	0.00	0.00	0.00
Total		0.00	0.00	0.00	0.00

[1] Extended Credit Facility (ECF), formerly PRGF.

[2] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement

The de jure arrangement is floating. The kip followed a depreciating trend against the U.S. dollar within a 2 percent band from mid-April 2013. Therefore, the de facto arrangement is reclassified retroactively as crawl-like from its previous classification as stabilized, effective April 18, 2013. The authorities' objective is to limit currency fluctuations vis-à-vis major currencies, including the U.S. dollar and Thai baht, within ±5 percent per annum. The Bank of the Lao P.D.R. (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. 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).

Article IV Consultation

The last Article IV consultation discussions were held in Vientiane during June 26–July 5, 2012 and were concluded by the Executive Board on August 31, 2012. The staff report (Country Report No. 12/286) was published on October 18, 2012.

Technical Assistance

Over the past three years, Lao P.D.R. has received technical assistance in the areas of customs and tax revenue administration; price statistics; external sector statistics; and the national accounts. A new Bangkok-based IMF office that will facilitate technical assistance to Lao P.D.R. as well as Myanmar was set up in September 2012.

Resident Representative

Mr. Sanjay Kalra assumed the Resident Representative post for Vietnam and Lao P.D.R., based in Hanoi, on October 16, 2011.

IMF-WORLD BANK COLLABORATION

The World Bank and the IMF country teams for Lao P.D.R. met on August 30, 2013 to discuss the economic outlook for Lao P.D.R. and the two teams' work for FY2014. The teams were led by Ms. Keiko Miwa (Country Manager, EASPR, World Bank), and Mr. Ashvin Ahuja (IMF Mission Chief for Lao P.D.R.).

The teams agreed that although Lao P.D.R. had made significant progress, macroeconomic policies have been overly expansionary, resulting in growing macroeconomic and financial sector vulnerabilities. Prudent fiscal and monetary policies, and a strengthening of policy frameworks, are essential to restore fiscal buffers, replenish international reserves, and safeguard banking sector soundness. Most urgently, fiscal policy needs to be put back on a consolidation path over the next few years, which will require lower growth in civil service compensation as well as reforms to public sector financial management.

In the longer run, a key challenge is to achieve more diversified growth, and ensure that the country's natural resource wealth is developed in a sustainable way that benefits the entire population.

Lao P.D.R.: Bank and Fund Planned Activities in Macro-Critical Structural Reform Areas, June 2013–May 2014

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1.World Bank Program	New series of Poverty Reduction Support Operations (PRSOs)	Preparatory work and missions throughout fiscal year 2013–14 (identification mission for PRSO 10 tentatively scheduled in early 2014)	Implementation throughout fiscal year. PRSO9 Board discussion in September 2013. PRSO 10 Board discussion expected in September 2014
	Customs and Trade Facilitation Project (CTFP) and Trade Development Facility (TDF)	Ongoing	Implementation throughout fiscal year TDF2 approved in September 2013
	Multi-Donor Trust-Fund Project supporting the Government Public Financial Management Strengthening Program (PFMSP)	Recently closed	September 2013
	Hydro-Mining Technical Assistance Project	Ongoing	Implementation throughout fiscal year 2014
	Technical Assistance on improving financial soundness indicators	Ongoing	Implementation throughout fiscal year 2014
	Lao Statistical Capacity Building Project (LAOSTAT)	Ongoing	Implementation throughout fiscal year 2014

Lao P.D.R.: Bank and Fund Planned Activities in Macro-Critical Structural (concluded)
Reform Areas, June 2013–May 2014

	Analytical work:		
	Macroeconomic monitoring (Lao economic monitors);	Ongoing	Approval expected in November 2013
	Investment climate, human resource development and skills reports	Ongoing	Reports available by June 2014
2. IMF Work Program	Periodic staff visits by IMF resident representative based in Hanoi	June 2013	May 2014
	Article IV Consultation	August–September 2013	Board discussion November 2013
	TA on improvement of external sector statistics	June 2013	BTO/TA report in July 2013
	TA on natural resources revenue administration (Series of six visits over 2013–16)	Ongoing	BTO/TA report following each visit
	TA on tax administration reform	Ongoing	Aide memoire in FY2014
	TA on bank supervision	December 2013 and Q1 2014	BTO/TA report in FY2014
3. Joint Work Program	External Debt Sustainability Analysis	September 2013	October 2013

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

The Asian Development Bank's (AsDB) current Country Partnership Strategy (CPS) 2012–2016 is aligned with the government's development strategy (National Socio-Economic Development Plan (NSEDP, 7th Five-Year Plan)), and seeks to promote inclusive and sustainable economic growth and poverty reduction. The country assistance program evaluation, 2000–09, concluded that the AsDB's assistance was successful, relevant, and effective. The CPS is designed to help the government diversify the economy in a sustainable and inclusive manner through agriculture and natural resources, education, energy, urban development, and public sector management. The CPS aims to maximize efficiency and sustainability through larger operations implemented over a longer period; maximize synergies with the Greater Mekong Subregion program; and increase responsiveness to emerging issues in a rapidly changing economy. It highlights four thematic areas that will influence the design and focus of activities, including private sector development, governance, gender equity, and regional cooperation and integration. The CPS focuses on four core sectors: education, agriculture and natural resources, water supply and other municipal infrastructure and services, and energy. Strengthening public sector management is a crosscutting issue, key to efficient and effective development in Lao P.D.R. The performance-based allocation of the Asian Development Fund (ADF), based on the country performance assessment (CPA) finalized in 2012, provided Lao P.D.R. with an ADF allocation in the amount of US$156.01 million for the biennial period 2013–14. The CPA for the next allocation period (2015–2016) will be finalized by the end of 2014.

As of end-2012, cumulative loans/grants approved stood at US$752.94 million, out of which a cumulative amount of US$313.84 million was awarded for contracts. During 2012, US$68.61 million were disbursed and US$73.65 million of contracts were awarded. Four new technical assistance (TA) projects for a total of US$3.8 million were approved in 2012, including project preparation; TA projects related to the water supply and sanitation project; human resource development strategy; capacity building TA to strengthen the National Commission for Advancement of Women, supporting decentralized rural infrastructure and implementing regulatory impact assessment.

Lao P.D.R.: Asian Development Bank Commitments and Disbursements, 2002–12 1/

(In millions of U.S. dollars)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Commitments	43.2	34.9	54.8	87.0	60.7	47.4	46.6	81.2	55.3	53.20	73.65
Disbursements	48.6	54.7	48.5	78.7	76.8	74.8	56.9	75.9	61.5	73.23	68.61

Source: Data provided by the Asian Development Bank.

1/ Starting from 2006, the commitments and disbursements included both loans and grants.

2/ The commitments and disbursements are as of December of each year

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

General: Data provision has serious shortcomings that significantly hamper surveillance, especially regarding national accounts, government finance, financial sector and external sector statistics. These shortcomings are due to a lack of capacity. During the recent Article IV mission, senior staff from STA held a high level seminar with government officials to discuss a strategy for improving statistics to support the country's development goals. A comprehensive technical assistance (TA) and training program was agreed to address the specific needs, covering the areas of national accounts, prices, government finance statistics, monetary and financial statistics, and external sector statistics.

National accounts:
National accounts (NA) comprise annual estimates of GDP by activity at current and constant prices (base year =2002), broadly following the System of National Accounts (SNA) 1993. The present methodology for compiling annual GDP by activity at current and constant prices largely uses outdated indicators and ratios, which has affected the accuracy and the quality of GDP. A program of surveys has been set up to improve the situation. The Lao Statistics Bureau (LSB) conducted an economic census in 2012–2013 with the aim of constructing a business register to be used for an annual establishment survey for NA compilation. Lao P.D.R. participates in the IMF's Statistics Department (STA) project to implement the SNA and International Comparison Project (ICP), funded by the government of Japan, and has received technical assistance (TA) to improve annual national accounts and develop quarterly national accounts (QNA). Following a February 2013 TA mission under this project, collection of quarterly data is scheduled to commence in March 2014, and the LSB plans to implement some methodological improvements at the same time. The first set of QNA is planned to be released early 2015. GDP by expenditure has not been published since 2005. Based on advice provided by a December 2011 mission, the LSB has compiled preliminary GDP by expenditure in current prices for 2007–2011 with 2007 as the base year. Compilation of GDP by expenditure at constant prices is in progress based on deflators discussed during the February 2013 mission.

Prices statistics:
Lao P.D.R. compiles a monthly CPI (December 2010=100) using weights based on the 2007/08 Lao Expenditure and Consumption Survey. A monthly producer price index (PPI), which is to be compiled on a quarterly basis, is currently under development. Its coverage is restricted to mining and quarrying, manufacturing, and electricity. In the medium term, coverage is to be expanded to include tourism and construction activities, and in the long term, to include agriculture, services and other activities.

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 for government finance statistics. Except for the annual data disseminated in the Official Gazette, no fiscal data are disseminated in the country. A mission took place during July 2013 to initiate participation in the Government Financial Statistics TA project funded by the Government of Japan through the Japan Administered Account for Selected IMF activities (JSA) and to launch an enhanced GFSM2001 compilation system starting with an in-country training workshop in August 2013.

Monetary statistics: The classification of monetary data by institutional sector and by financial instrument as well as valuation principles need to be strengthened. The Standardized Report Forms (SRFs), which embody the IMF-recommended framework for compiling monetary statistics, have yet to be introduced. The authorities have requested a one-week MFS training mission that is planned for late January 2014.

External sector statistics:

Data gaps in external sector statistics include the need to implement BPM6, the compilation of the capital account, IIP and external debt statistics (EDS), and there are issues with the periodicity and timeliness of reporting. Limitations on financial resources and the number of compilers have constrained the LSB and the Bank of Lao PDR (BOL) from achieving progress in the compilation of IIP and EDS as initially expected.

Data Standards and Quality

Lao P.D.R. is currently not a General Data Dissemination System (GDDS) participant. The government has expressed its intention to collaborate with the IMF in moving Lao's macroeconomic statistics closer to the international standards, including to join the IMF's GDDS, and use it as a framework for development of the national data compilation and dissemination practices. No Data ROSC mission has been conducted.

Reporting to STA

Government finance statistics reporting for publication in the International Financial Statistics (IFS) and the Government Finance Statistics Yearbook, which was initiated in early 2009, is limited to budgetary central government and has been irregular and with long delays. Lao P.D.R. reports quarterly and annual summary budget data in the *GFSM 2001* format for publication in *IFS* and the *GFS* Yearbook, with a time lag of six months or more, and on an irregular basis.

The reporting of monetary data is irregular and also with long delays. Quarterly BOP data are reported once a year in a highly aggregated format. The last published data in the IFS and the Balance of Payments Statistics Yearbook correspond to 2011.

Table of Common Indicators Required for Surveillance

As of October 8, 2012

	Date of Latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]
Exchange Rates	10/08/13	10/08/13	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	June 2013	08/27/13	M	I	Q
Reserve/Base Money	June 2013	08/27/13	M	I	Q
Broad Money	June 2013	08/27/13	M	I	Q
Central Bank Balance Sheet	June 2013	08/27/13	M	I	Q
Consolidated Balance Sheet of the Banking System	June 2013	08/27/13	M	I	Q
Interest Rates[3]	August 2013	10/03/13	M	M	M
Consumer Price Index	August 2012	09/05/13	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4]—General Government[5]	June 2013 for Expenditure; July for Revenue	10/04/13	I	I	I
Revenue, Expenditure, Balance and Composition of Financing[4]—Central Government	June 2013 for Expenditure; July for Revenue	10/04/13	Q	I	M
Stocks of Central Government and Central Government-Guaranteed Debt[6]			NA	NA	NA
External Current Account Balance	Q2 2013	08/27/13	Q	I	I
Exports and Imports of Goods and Services	Q2 2013	08/27/13	Q	I	I
GDP/GNP	2011/12	09/16/13	A	A	A
Gross External Debt	Dec 2012	09/20/13	A	A	I
International Investment Position[7]			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 of 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 Including currency and maturity composition.

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

Statement by the Staff Representative on Lao P.D.R.

November 15, 2013

1. This statement provides information that has become available since the staff report was circulated to the Executive Board on October 31, 2013. This information does not alter the thrust of the staff appraisal.

2. Inflation edged down slightly on a year-on-year basis to 6.7 percent in October, from 6.9 percent in September.

3. International reserves increased modestly to US$583 million at end-September (0.9 months of prospective imports) from US$532 million at end-June (0.8 months of prospective imports).

4. Overall credit growth was 31½ percent year-on-year in September, up from 28¼ percent in June.

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 13/472
FOR IMMEDIATE RELEASE
November 26, 2013

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation with Lao People's Democratic Republic

On November 15, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Lao P.D.R.

Background

Lao P.D.R. continued to make progress towards achieving the Millennium Development Goals (MDGs) and became a member of the World Trade Organization (WTO) in 2013. Over the past year, however, the economy has been overheating from expansionary macroeconomic policies. The fiscal deficit is estimated to have widened to 6½ percent of GDP, mainly from a doubling of public sector employee compensation and higher capital spending. Government liquidity is tight, and wage and other arrears of 2–3 percent of GDP have emerged. Monetary policy has been accommodative, and credit growth remains vigorous. Real GDP growth is projected at 8¼ percent this year, led by investment and private consumption, and consumer price inflation is projected to rise to 7½ percent by year-end. The current account deficit is expected to remain close to 30 percent of GDP, and despite strong foreign direct investment inflows, international reserves—amounting to US$0.5 billion (0.8 month of prospective imports) in June 2013—are very low.

[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.

While medium-term growth prospects remain favorable, based on robust natural resource exports and post-WTO expansion in the non-resource sectors, heightened vulnerabilities have subjected the outlook to considerable uncertainty. A recent tightening of public employee compensation and public investment should reduce the headline fiscal deficit to 4 percent of GDP in 2014, although the current account deficit is expected to remain high owing to an overvalued real effective exchange rate, and reserve levels would remain inadequate for precautionary needs. After years of rapid credit expansion, banks' asset quality could deteriorate. If policies remain expansionary, near-term pressures on the balance of payments and inflation could escalate, further depleting international reserves, and putting at risk the sustainability of future growth and the authorities' objective to achieve middle-income status by 2020.

Executive Board Assessment[2]

The Executive Directors commended the authorities for their impressive economic growth record and the significant progress made toward achieving the MDGs. While medium-term economic prospects remain broadly favorable, expansionary macroeconomic policies have led to a sharp deterioration of fiscal and external balances. To address growing vulnerabilities, Directors emphasized the immediate need to further tighten fiscal and monetary policies to support the exchange rate anchor, replenish international reserves, build up fiscal buffers, and guide the economy toward a soft landing.

Directors stressed that fiscal consolidation is central to restoring macroeconomic stability. They agreed that a more ambitious tightening, anchored by a nonmining fiscal deficit of no more than 5 percent of GDP, would help to restore the fiscal space necessary for adequate capital and human development spending, and would safeguard debt sustainability. Directors welcomed the authorities' intention to restrain the increase in public sector compensation in 2014, and recommended that future increases be implemented at a more measured pace. A medium-term budget strategy and continued improvements in tax collection would be important components of any fiscal consolidation effort. Directors further underscored that cautious assessment of large-scale projects and strengthening of public debt management capacity will be required to mitigate debt sustainability risks.

[2] 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.

Directors recognized that the authorities' commitment to a stabilized exchange rate within a reasonably wide and adjustable band has contributed to increased confidence and to de-dollarization over time. They emphasized that the exchange rate anchor requires lower broad money and credit growth, and in this context they urged the authorities to mop up excess liquidity, accelerate the unwinding of quasi-fiscal lending, and raise policy interest rates. Noting that the exchange rate is assessed to be overvalued, and given inadequate reserves, Directors recommended that the kip be allowed to move in line with market conditions with a view toward replenishing international reserves.

Directors noted that years of rapid credit expansion and possible currency mismatches on bank balance sheets pose risks to financial sector stability. They underscored the need for further efforts to strengthen financial supervision, improve compliance with macroprudential regulation, and raise banks' capital. Directors encouraged the authorities to participate in an FSAP, and to use Fund technical assistance to address supervisory weaknesses and strengthen financial stability and crisis management frameworks. They welcomed efforts to strengthen the anti-money laundering and combating the financing of terrorism regime.

Directors welcomed Lao P.D.R.'s recent WTO accession, which should facilitate greater economic diversification. They encouraged further efforts to enhance the business climate, upgrade economic and financial statistics, and improve health and education infrastructure, which would contribute to more inclusive and broader-based growth and would support the authorities' goal of attaining middle-income status by 2020.

Table. Lao P.D.R.: Selected Economic and Financial Indicators, 2010–14[1/]

	2010	2011	2012	2013	2014
			Est.	Proj.	
GDP and prices (percentage change)					
Real GDP growth	8.1	8.0	7.9	8.2	7.5
CPI (annual average)	6.0	7.6	4.3	6.5	7.5
CPI (end year)	5.8	7.7	4.7	7.4	7.7
Public finances (in percent of GDP)					
Revenue	18.3	18.3	19.6	19.6	20.6
Of which: Resources	2.6	3.3	3.8	3.2	3.4
Of which: Mining	1.8	2.5	3.1	2.3	2.5
Of which: Hydro power	0.8	0.8	0.8	0.9	0.9
Of which: Grant	2.3	2.2	2.1	1.8	1.7
Expenditure	23.0	21.3	21.0	26.1	24.5
Expense	12.5	12.1	12.7	17.2	16.7
Net acquisition of nonfinancial assets 2/	10.6	9.2	8.2	8.9	7.8
Net lending/borrowing	-4.7	-3.0	-1.4	-6.5	-3.8
Net lending/borrowing including discrepancy	-4.7	-3.1	-4.8	…	…
Nonmining balance 3/	-6.5	-5.5	-4.5	-8.8	-6.4
Nonmining balance including discrepancy 3/	-6.5	-5.6	-7.9	…	…
Money and credit (annual percent change)					
Reserve money	48.6	16.2	27.2	12.7	14.9
Broad money	39.5	28.7	31.0	24.7	20.8
Bank credit to the economy 4/	48.4	45.8	26.6	32.9	19.4
Bank credit to the private sector	48.4	39.3	35.1	34.2	21.0
Balance of payments					
Exports (in millions of U.S. dollars)	2,196	3,120	3,323	3,451	3,661
In percent change	44.4	42.1	6.5	3.9	6.1
Imports (in millions of U.S. dollars)	3,574	4,635	6,355	6,940	7,242
In percent change	23.6	29.7	37.1	9.2	4.4
Current account balance (in millions of U.S. dollars)	-1,251	-1,243	-2,606	-2,946	-2,956
In percent of GDP	-18.2	-15.2	-28.4	-29.5	-27.3
Gross official reserves (in millions of U.S. dollars)	728	677	740	666	712
In months of prospective goods and services imports	1.8	1.2	1.2	1.1	1.1
(Excluding imports associated with large resource projects)	2.6	1.7	1.7	1.5	1.5
External public debt and debt service					
External public debt					
In millions of U.S. dollars	3,539	3,664	4,221	4,611	5,167
In percent of GDP	50.3	44.8	46.1	47.4	49.1
External public debt service					
In percent of exports	4.4	2.7	4.1	5.6	5.4
Exchange rate					
Official exchange rate (kip per U.S. dollar; end-of-period)	8,040	8,002	7,992	…	…
Real effective exchange rate (2000=100)	125.2	127.6	133.7	…	…
Nominal GDP					
In billions of kip	56,523	65,398	73,257	82,260	94,041
In millions of U.S. dollars	6,855	8,162	9,169	10,002	10,814

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

1/ Public finances are on a fiscal year (October to September) while other data are on a calendar year.

2/ Includes off-budget investment expenditures.

3/ Net lending/borrowing excluding mining revenue.

4/ Includes Bank of Lao P.D.R. lending to state-owned enterprises and subnational levels of government.

Statement by Mr. Abdul Ghaffour, Alternate Executive Director for Lao P.D.R. and Ms. Nithiwadee Soontornpoch, Senior Advisor to Executive Director

November 15, 2013

1. Our Lao authorities wish to express their appreciation to Mr. Ahuja and his team for the constructive discussions and comprehensive assessment, as well as valuable recommendations made during the recent Article IV consultation. This year's consultation focused on the challenges of sustaining economic growth, while safeguarding macroeconomic and financial stability in the face of inflation and balance of payment pressures. The authorities broadly agree with the staff appraisal and will thoughtfully consider the policy recommendations therein.
2. Fifteen years after first sought membership, Lao PDR became the 158th member of the World Trade Organization (WTO) on February 2, 2013. Accession to the WTO will provide Lao PDR with more market opportunities by diversifying list of trading partners, help realize higher gains from trade, and enhance investor confidence. As Lao PDR enters the third year of the seventh five-year National Social and Economic Development Plan (7th NSEDP, 2011-2015), the midterm review have found that the plan has been successful in improving the people's livelihood. Substantial progress towards the Millennium Development Goals (MDGs) has been achieved especially on poverty headcount that dropped further to 20 percent in 2012. The government remains committed to press ahead with necessary policy actions to overcome remaining obstacles to achieve the 2015 MDGs target and graduate from least developed country status by 2020 (Vision 2020).

Recent Economic Development and Outlook

3. Despite the weaker global growth and external uncertainties, the Lao economy continued to grow in line with the medium-term target of 8 percent in 2012, significantly driven by thriving investment projects in hydropower, infrastructure, and real estate construction as well as domestic consumption. Mining production has increased significantly from the operation of new gold and silver mines and the expansion of existing minerals projects. With the continued strong growth of FDI, the authorities expect to maintain the same pace of expansion in 2013, fueled by hydropower and labor-intensive sectors, including construction, manufacturing, agriculture and services.
4. Although fiscal revenue collection exceeded the target in 2012, fiscal deficit has deteriorated in fiscal year 2012/2013 due to the increase in wages and monthly allowance for civil servants and lower-than-targeted revenue collection. Nevertheless, the authorities are committed to rein in fiscal deficit at 5 percent of GDP by stepping up efforts in tax administration and collection along with expenditure measures. The authorities are more optimistic on the prospect of higher tax revenue for fiscal year 2013/2014 from new foreign investment projects and other income measures including the unification of corporate income tax rates, the introduction of a lump-sum tax for

SMEs, taxes on property transfer, as well as increases in petrol and vehicle excise duties.

5. The average inflation in 2012 was moderate at 4.26 percent, but has escalated to 6.22 percent over the period of first nine months of 2013 due to prices of food and nonalcoholic beverages category, particularly meats and rice, going up by 12.3 percent caused by the shortage of livestock and the effects of flooding on agriculture. In addition, price index of restaurant-hotel category, as well as housing, water supply, electricity and fuel category also increased by 8.6 percent and 7.7 percent, respectively. Nonetheless, the authorities expect that more stable prices of fresh food and fuel in the last quarter will bring inflation to an annual average of 6.34 percent.

6. The kip's nominal exchange rate appreciated 0.26 percent in 2012 and 0.62 percent in 09/2013 (y.o.y) against the US dollar. The authorities view that the kip appreciation is broadly in line with the movement of regional currencies and remains flexible within the target band. As noted in the staff report, they have carefully monitored and observed the phenomenon in the parallel exchange market, which has been trading at a premium over the Bank of the Lao PDR (BOL)'s reference rate since August 2013. Such irregularities were attributable to (i) temporary FX liquidity shortage of some commercial banks to fulfill customers' request; and (ii) market's misperception that the BOL might adjust its policy on foreign exchange transactions administration, which currently allows daily FX transaction up to kip 20 million per person. As a result, the gap between official and parallel markets was widened from less than 0.04 percent pre-August to a peak of 3.4 percent in early September. However, after the BOL continuously communicated their exchange rate policy stance to public and consistently adhered to the announced policy, the gap has narrowed down to 0.7 percent in late October. The international reserves level has declined, but gradually risen recently and is expected to increase to a more comfortable level by the end of 2013.

7. Growth of credit to the economy is expected to decelerate further to about 20.7 percent in 2013 from 26.6 percent last year. Notwithstanding a decelerating pace of credit growth and low NPL ratio, the authorities constantly strengthen its prudential regulations and banking supervision to ensure that financial system is safe and sound.

8. The authorities reiterate their steadfast commitment to pursue structural reform and attract quality foreign investments to drive sustainable development and more diversified economy. In conjunction with this effort, the government has temporarily suspended new land concessions for gold and copper mining projects until 2015 to conduct review and evaluation of the existing projects. Such assessment will ensure compliance with regulations and maximize its benefit to meet socio-economic development objectives.

9. The authorities share staff's views that several emerging challenges could pose downside risks to the economic outlook, and thus attach high priority to strengthening macroeconomic and financial stability. They generally agree that policy tightening may be warranted to address potential pressures on the external position and ensure inflation remains contained. To this end, the authorities will stay vigilant on any possible external shocks and stand ready to respond as appropriate.

Fiscal Policy

10. The authorities recognize the importance of fiscal prudence and concur that fiscal consolidation is crucial for preserving macroeconomic stability and public debt sustainability. They are aware that steps to rebuild fiscal buffers are needed to ensure fiscal sustainability as well as cushion adverse shocks and unavoidable events in the period ahead. However, the path of consolidation proves challenging due to the committed increase in civil service wages and unexpected revenue underperformance from sharply declined commodity export prices.
11. Against this backdrop, the authorities have promptly implemented measures to enhance tax collection and curb other non-critical public spending to compensate for larger wage bill envelope. On revenue front, the authorities are mapping out effective strategies to intensify its revenue collection and widen tax base. Tax administration has been strengthened by strictly enforcing compliance with investment promotion law regarding tax and duty exemption and VAT deductibles, as well as effectively implementing the revised tax law.
12. With regard to the expenditure, the government has temporarily halted the monthly living allowance payment to civil servants, which will help to reduce expenditure more than 2 percent of GDP. The authorities will carefully reconsider the policy on future civil servant salary compensation taking into account staff's recommendation of a more measured pace. In addition, the authorities have cut low-priority current expenditures and suspended state infrastructure development projects that are commissioned by local governments, financed by private contractor and repaid by the government upon completion of the projects. They will further carefully review procurement process and strengthen project management regulations according to the State Investment Law before lifting such suspension.
13. Over the medium-term, the authorities recognize that challenges remain in securing a more sustainable revenue stream especially from non-resource sector and enhancing the capacity on public financial management. Among others, they are in the process of imposing new valuation method for automobile and fuel imports, which would contribute to higher customs duty and tax collection. A new 5 percent tax on value of real estate transactions has also taken effect in 2013. The full implementation of the revised tax law which has been approved in 2011 will contribute to higher income tax from new foreign investment projects.
14. Despite higher pressures on fiscal accounts, the authorities are committed to keep public debt on a sustainable path and target to reduce level of external debt to be less vulnerable to external shocks. The bath bond issuance in Thailand, which is a pilot project to access the external financial market under the ASEAN+3's Asian Bond Markets Initiative (ABMI), has been a resounding success as proved by almost three times oversubscription. The Debt Management and Financial Analysis System (DMFAS) has been rolled out which will significantly improve public debt data recording and strengthen debt management capacity.

Monetary and Exchange Rate Policies

15. On the back of heightened inflationary pressures, monetary policy has been geared towards preserving macroeconomic stability. The authorities take note of staff's recommendation that monetary policy should be tightened by lowering M2 growth to the level consistent with a sustainable nominal GDP growth in order to anchor inflation.
16. The BOL has tightened monetary policy by continuously issuing central bank bills, hiking repurchase interest rates - from 3.5 percent to 6.55 percent for kip and from 2.65 percent to 3.93 percent for FX, strictly enforcing FX net open position regulation, as well as rationally providing FX liquidity support to commercial banks. Under current circumstances, the BOL deems raising banks' reserve requirement ratios as a last resort. The BOL's bills are regularly used to absorb liquidity and mobilize funds from excess liquidity in banking system and can be additionally issued as necessary.
17. The BOL remains committed to keep exchange rate flexible and in line with financial and economic conditions. In light of recent irregular movements in FX market, rules and regulations on foreign currency related operations are enforced more actively. Commercial banks must pay up the registered capital in foreign currency according to capital adequacy regulation, and may extend credit in foreign currency only for the activities that can generate revenues in foreign currency. These efforts specifically aim at containing risks of currency mismatches in bank balance sheets. On this note, the BOL is preparing to request for a technical assistance in the development of the interbank market.
18. The authorities welcome staff's assessment that the current exchange rate policy is a generally appropriate anchor, which has contributed to increased confidence in the kip. The authorities are committed to maintain a stabilized exchange rate scheme while pursuing de-dollarization objective and promoting greater use of the kip. In addition, the authorities are taking steps to enhance the mechanism for regulating foreign exchange transactions to be able to monitor daily trading activities in a more real-time basis.
19. Realizing the importance of safeguards against external uncertainties, the BOL has stepped up their efforts to augment international reserve. Measures that have been implemented include an abortion of foreign currency lending to local governments and state-owned enterprises since last year, collecting outstanding loans, and intensifying enforcement of foreign currency related regulations. In spite of the widening current account deficit, the authorities are more optimistic that current international reserve level remains adequate at 2.9 months of officially reported imports data in June 2013. More importantly, the level of foreign reserves has gradually increased recently and is expected to reach a more comfortable level at the end of the year. The authorities are of the view that 2013 import figures would slow down from 2012, which witnessed high import volume related to the ASEM meeting preparation. They also urge staff to be cautious in using trading partners' export data as proxy for Laos' import, as a significant part of the unrecorded import content is re-exported to other countries. That said, the authorities are in agreement that there could be scope for exploring the

discrepancy in the measurement of imports and enhancing the authorities' data collection system.

Financial Sector

20. The BOL considers sound and robust financial system crucial for efficient allocation of financial resources for long-term economic development. The overall banking sector remains sound with strong capital adequacy, ample liquidity, and low NPL. The authorities view credit growth as a positive move toward financial deepening, which is a driver of economic growth and poverty alleviation. Nonetheless, the BOL is aware of potential risks from extended period of rapid credit growth, thus has tightened prudential regulation for banks to closely monitor credit quality and supervisory interventions to ensure good quality underwriting standard, especially for banks with NPL ratio of more than 3%. Regulations to control single lending limit to mitigate concentration risk and prohibit connected lending to shareholders, directors and subsidiaries have recently been issued.
21. More importantly, plans are underway to adopt Basel II capital standard with technical support from the WB and the Bank of Thailand. In tandem, supervisory capacity and regulatory framework are being strengthened to preserve a safe and sound banking system. These efforts along with ongoing enhancement of the regulatory framework under the ASEAN Banking Integration Framework will help to improve banking capacity and enhance financial stability.
22. To address the deficiency of AML/CFT regime, the authorities have drafted AML/CFT Law, and are in the process of several consultations and reviews by the Ministry of Justice. The World Bank will subsequently help review the draft law to ensure its compliance with international standards and, tentatively, the BOL will propose draft AML/CFT Law to the National Assembly by 2014.

Structural Reforms

23. Lao PDR has become the 158th member of WTO in February 2013 and Lao PDR has granted foreign access to domestic in several sectors. Significant progress was achieved on structural reforms where more than 90 laws and regulations were enacted, including those related to import licensing, custom valuation, investment, sanitary and phytosanitary measure, technical barriers to trade, as well as intellectual property right in order to better align with international norms. The authorities also continue their efforts in simplifying business start-up procedures, notably with the establishment of a one-stop shop to coordinate the application for foreign investment in the country through various levels and spheres of approval. Electronic data interchange system has been modernized to better facilitate cross-border trades. Additionally, Lao trade portal (www.laotradeportal.gov.la) has been introduced to facilitate trade and enhance transparency. The authorities believe that these initiatives will create a favorable business climate conducive to more broad-based and inclusive growth.
24. The authorities realize the importance of high-quality and comprehensive set of macroeconomic and financial sector statistics for conducting economic surveillance and formulating appropriate and timely policy responses. In view of the need for

producing and disseminating these statistics in line with the international guidelines, efforts are made toward improving official statistics and the reporting system. The authorities welcome the Fund's technical assistance to enhance statistical capacity.

Conclusion

25. The government envisages the Lao PDR to achieve LDC graduation by 2020. With such ambitious undertaking, the authorities reaffirmed their commitment to carry out the 7th national socio-economic plan in a manner that would sustain the investment and growth momentum, while simultaneously preserving macroeconomic and financial stability. They are aware of many challenges ahead and intend to gear the efforts towards enhancing business environment, improving efficiency of public services, reforming public financial management, building up necessary fiscal and monetary policy space as well as strengthening banking regulation. Our authorities welcome productive policy dialogue with the mission team and wish to express their appreciation to the continued support of the Fund, especially in the area of technical assistance.