INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/84

LAO PEOPLE'S DEMOCRATIC REPUBLIC

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR LAO PEOPLE'S DEMOCRATIC REPUBLIC

March 2018

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 2017 Article IV consultation with Lao People's Democratic Republic, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 26, 2018 consideration of the staff report that concluded the Article IV consultation with Lao People's Democratic Republic.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 26, 2018, following discussions that ended on December 13, 2017, with the officials of Lao People's Democratic Republic on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 7, 2018.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the International Development Association (IDA).
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Lao People's Democratic Republic.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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February 23, 2018

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IMF Executive Board Completes the 2017 Article IV Consultation with Lao People's Democratic Republic

On February 26, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation with Lao P.D.R.[1]

Lao P.D.R.'s economy continues to perform well, supported by a favorable external environment and strong flows of foreign direct investment from its dynamic neighbors. Growth in 2017 was supported by the expansion of electricity exports, construction activity and financial services, but moderated to 6.8 percent as a result of the prohibition on illegal logging, tighter credit conditions and fewer tourist arrivals. Inflation remained low at 0.2 percent in December 2017, reflecting a stable exchange rate and a decline in food prices. Private sector credit growth was robust at 17 percent year-on-year in 2017, a pace consistent with dynamic economic activity and moderate financial deepening. The current account deficit was high at 13 percent of GDP in 2017, although it is estimated that about half the deficit reflected imports related to large foreign direct investment projects, including the Kunming-Vientiane railway project, which is part of China's Belt and Road Initiative. Nevertheless, gross international reserves remain low at about 1 month of prospective imports.

The authorities have developed a reform agenda to address some of the vulnerabilities in the economy, with the goal of supporting stable and sustainable growth to graduate from Least Developed Country (LDC) status. Aware of the challenges presented by high public debt and deficits, they are moving to put in place a gradual fiscal consolidation mainly through tax policy

[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.

and administration reforms. They are also moving to strengthen the banking system by recapitalizing and restructuring public banks, restructuring loans related to infrastructure projects and improving regulation and supervision. The authorities have also focused on integrating the Sustainable Development Goals (SDGs) into their 5-year development plan to promote inclusion and environmental sustainability.

Looking ahead, the outlook is positive, with growth on the order of 7 percent per year, and gradual economic diversification matched by integration with ASEAN and China. Downside risks stem from high public debt and deficits, pockets of weakness and high dollarization in the banking sector, and a vulnerable external position with low gross international reserves. Addressing these risks and successfully implementing the authorities' reform agenda will help ensure sustainable and inclusive growth and graduation from LDC status.

Executive Board Assessment[2]

Executive Directors welcomed Lao P.D.R.'s good record of high growth and stable inflation. However, they noted vulnerabilities in key areas, in particular, a high fiscal deficit and public debt, a weak external sector and low external reserves, and a highly-dollarized banking system. While the outlook is for continued high growth, risks could materialize if government finances do not improve, or if external conditions deteriorate, which could be amplified in the domestic economy through negative macro-financial feedback loops. Directors encouraged the authorities to continue to address these risks.

Directors stressed the importance of a gradual fiscal consolidation to bring the public debt on a credible but realistic downward path over the medium term. They agreed that this could best be done by improving fiscal revenue, and welcomed the authorities' interest in developing a medium-term revenue strategy. They noted that there is also scope to rationalize expenditures and reorient spending to improve health and education outcomes, and welcomed efforts to contain the wage bill. Directors recommended stronger debt management and a more rigorous selection of public investment projects.

Directors welcomed the progress in strengthening banking regulation and supervision and the reform of public banks, but noted that further efforts are needed to reduce foreign currency lending risks, identify non-performing loans, and strengthen capital buffers. They took positive note of the prospects for putting in place crisis management and prompt corrective action frameworks, and the progress in developing the AML/CFT regime.

While noting that external sector vulnerabilities are being ameliorated, Directors considered that the overvaluation of the exchange rate and the high current account deficit call for a further

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[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.

accumulation of international reserves. They welcomed the gradual depreciation of the exchange rate and recommended letting the exchange rate move gradually within the official band to support competitiveness and help accumulate reserves. They agreed that a cautious approach is warranted, given possible currency mismatches in the non-bank private sector. They noted that further reforms to improve the functioning of the interbank and domestic debt markets are important steps to put in place the preconditions for greater exchange rate flexibility in the medium term. A number of Directors urged removal of the interest rate caps.

Directors noted that the gap between income per capita and welfare indicators points to the need to pursue more inclusive and sustainable growth. To promote economic diversification, developing public infrastructure and improving conditions for private investment will be critical. Improvements in human capital will also be important, in particular through workforce training, public education, and health services, particularly for women and children. This will help reduce regional and gender disparities.

Directors called for improvements in economic statistics and welcomed the authorities' interest in joining the General Data Dissemination System.

Lao P.D.R.: Selected Economic and Financial Indicators, 2013–19

	2013	2014	2015	2016	2017 Proj.	2018 Proj.	2019 Proj.
GDP and prices (percentage change)							
Real GDP growth	8.0	7.6	7.3	7.0	6.8	6.8	7.0
CPI (annual average)	6.4	4.1	1.3	1.6	0.9	2.3	3.1
CPI (end year)	6.6	2.4	0.9	2.5	0.9	2.6	2.9
Public finances (in percent of GDP)							
Revenue and Grants	20.9	21.0	17.9	15.8	16.7	17.0	17.4
Of which: Resources	2.9	2.1	1.6	1.6	1.7	1.3	2.0
Of which: Mining	2.1	1.8	1.3	0.9	0.9	0.7	1.0
Of which: Hydro power	0.8	0.9	0.8	0.8	0.9	0.6	1.0
Of which: Grant	4.8	4.5	2.2	1.4	1.8	1.8	1.8
Expenditure	25.2	23.8	22.4	20.5	21.5	21.2	21.5
Expense	14.0	13.8	14.2	14.5	13.5	13.1	13.4
Net acquisition of nonfinancial assets 1/	11.1	10.1	8.1	6.0	8.0	8.1	8.1
Overall balance	-4.3	-2.8	-4.5	-4.6	-4.8	-4.3	-4.1
Nonmining balance 2/	-6.2	-4.6	-5.4	-5.5	-5.7	-5.0	-5.1
Public and public guaranteed debt (in percent of GDP)	56.3	57.9	57.7	58.5	61.1	65.3	65.9
Money and credit (annual percent change)							
Reserve money	7.7	30.3	6.6	-1.4	9.9	9.4	10.2
Broad money	18.8	23.4	14.7	10.9	12.9	22.8	22.0
Bank credit to the economy 3/	34.5	14.2	16.8	20.9	15.0	18.5	17.0
Bank credit to the private sector	36.3	11.7	19.3	22.0	16.5	16.7	15.0
Balance of payments							
Exports (in millions of U.S. dollars)	3,501	4,299	3,743	4,379	5,084	5,303	5843
In percent change	5.4	22.8	-12.9	17.0	16.1	4.3	10.2
Imports (in millions of U.S. dollars)	7,163	7,817	7,366	6,636	7,538	8,313	8822
In percent change	15.1	9.1	-5.8	-9.9	13.6	10.3	6.1
Current account balance (in millions of U.S. dollars)	-3,400	-2,657	-2,586	-1,903	-2,204	-2,728	-2751
In percent of GDP	-28.4	-20.0	-18.0	-12.0	-13.0	-14.9	-13.7
Gross official reserves (in millions of U.S. dollars)	662	816	987	815	979	1,023	1224
In months of prospective goods and services imports	1.0	1.3	1.7	1.2	1.3	1.3	1.5
Exchange rate							
Official exchange rate (kip per U.S. dollar; end-of-period)	8,030	8,096	8,119	8,231	8,279	…	…
Real effective exchange rate (2010=100)	113.9	120.9	131.1	134.5	125.9	…	…
Nominal GDP							
In billions of kip	93,868	106,797	117,252	129,279	140,019	152,822	168,514
In millions of U.S. dollars	11,974	13,266	14,363	15,916	16,984	…	…

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

1/ Includes off-budget investment expenditures.

2/ Net lending/borrowing excluding mining revenue.

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

INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

February 7, 2018

KEY ISSUES

Context. Growth remains robust, supported by electricity exports, construction and services. Inflation is contained as food prices have fallen. High public debt and fiscal deficits pose a key risk, while negative macrofinancial feedbacks through the banking system could propagate external shocks. The authorities are moving to implement reforms consistent with past advice, including the integration of the Sustainable Development Goals (SDGs) in their 5-year plan, but further reforms are needed.

Main Policy Recommendations

Policies should focus on reducing fiscal and banking system vulnerabilities and rebuilding buffers to ensure sustainable growth while putting in place the conditions for exchange rate flexibility in the future and for diversification and more inclusive growth. Key elements of the policy strategy include:

- Fiscal Policy: Anchor the public debt ratio at 50 percent of GDP and implement revenue reforms to lower the public deficit to about 2½ percent of GDP on average over the next five years, while reorienting expenditure toward public investment and social spending.
- Monetary and Exchange Rate: Allow the exchange rate to depreciate gradually to help regain competitiveness and accumulate reserves, while removing interest rate caps. Begin reforms of the interbank and public debt markets to support movement to a more flexible monetary framework and reduce dollarization.
- Banking System. Reduce foreign currency lending risks, identify NPLs and strengthen capital buffers. Put in place prompt corrective action and crisis management frameworks.
- Structural Reforms. Develop the framework for public infrastructure while facilitating private investment. Improve education and health outcomes, particularly for women and children. Upgrade statistics for economic policymaking and tracking the attainment of the SDGs.

Approved By
Markus Rodlauer and Ms. Yan Sun

Discussions took place during November 29–December 13, 2017. The staff team comprised G. Bannister (Head), S. Rafiq, A. Oeking, and V. Long (all APD), Y. Sugayama (MCM) and J. Dunn (Resident Representative). The mission team was assisted greatly by A. Kounnavong, L. Pharakhone, and V. Savannarideth in the Lao P.D.R. Resident Representative Office. Ms. Villa and Mr. Sanoubane (OED) joined the concluding meetings. Mr. Rattanasena and Ms. Gjonbalaj assisted in preparation of this report.

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APPENDICES

CONTEXT

1. **High growth has been accompanied by rising vulnerabilities.** Poverty has fallen, and Lao P.D.R. has made progress towards its goal of graduation from Least Developed Country (LDC) status.[1] But public debt has risen, and falling commodity prices have laid bare fiscal rigidities. A high current account deficit, a tightly managed and overvalued exchange rate, and low reserves leave the economy vulnerable to external shocks.[2] The banking system remains highly dollarized, with weak profits and pockets of fragility. Capital-intensive growth based on mining and hydropower investments has been accompanied by rising inequality and environmental degradation. For Lao P.D.R. to take advantage of its strategic location, with dynamic trading partners and opportunities for regional integration, it needs to address these vulnerabilities and put in place conditions for sustainable inclusive growth.

2. **The government recognizes these challenges and has charted a plan for reform, consistent with past IMF advice**. It is moving to put in place the conditions for a fiscal consolidation, focusing on tax policy and administration, and has allowed some (albeit limited) currency depreciation. It has recapitalized the largest public bank and plans to restructure two smaller public banks with foreign investors, and improve regulation and supervision. The authorities have also focused on integrating the Sustainable Development Goals (SDGs) into their 5-year development plan to promote more inclusive and sustainable growth. Nevertheless, high dollarization and a tightly managed exchange rate continue to constrain monetary policy, and gross international reserves, at one month of prospective imports, are well below the recommended levels.

DEVELOPMENTS, OUTLOOK, AND RISKS

3. **Growth remains robust and inflation subdued.** Growth in 2017 continued to be supported by electricity exports, construction and services (wholesale and retail trade and real estate), although it slowed slightly to 6.8 percent due to the prohibition on illegal logging, tighter lending conditions, and fewer tourist arrivals. Year-on-year CPI inflation remained low at 0.2 percent in December 2017 due mainly to a decline in food prices, while core inflation (excluding food and fuels) is around 1.7 percent. Medium-term growth is expected to remain high at around 7 percent, supported by new hydropower projects and strong FDI from China in agriculture, manufacturing assembly and services, including the construction of the Kunming – Vientiane railway under the Belt and Road Initiative (BRI) which began in early 2017 (Lao P.D.R. Debt Sustainability Analysis - Box 1).

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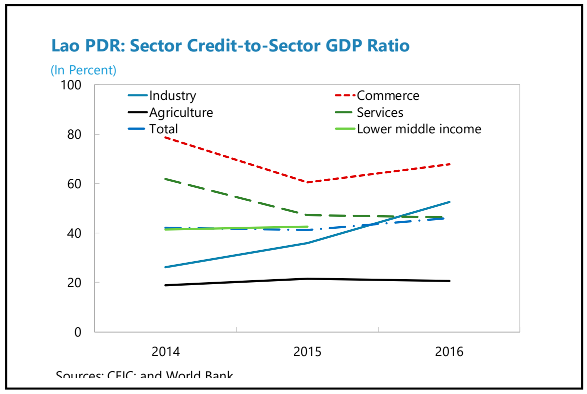
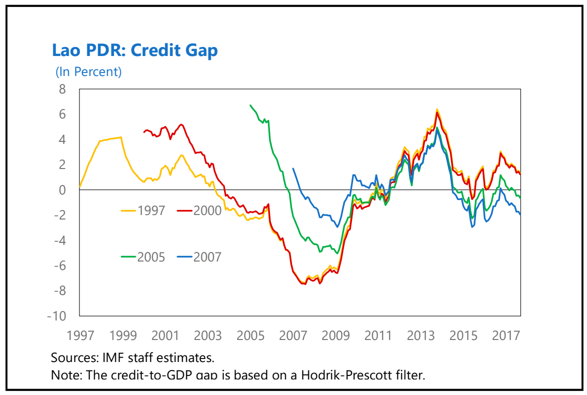
[1] Lao P.D.R.'s aspiration, as stated in 8th National Socio-Economic Development Plan (NSEDP), is to graduate from LDC status by 2020. An upcoming Triennial Least Developed Countries (LDC) Review, to be held in 2018 by the UN Committee for Development Policy (CDP) will determine how close Lao P.D.R. is to reaching the threshold for graduation.

[2] The de jure exchange rate arrangement is a managed float, but the de facto classification has been changed from a "stabilized arrangement" to a "crawl-like" arrangement in late 2016 and 2017 as the kip has followed a depreciating trend (by about 2 percent in total) with respect to the U.S. dollar.

4. Credit growth has slowed to more sustainable levels, consistent with moderate financial deepening. The growth of credit to the private sector in kip remains robust at 17 percent (y/y) and credit gap analysis suggests that this is a more sustainable level compared to very high rates of credit growth up to 2014. The ratio of credit-to-GDP rose rapidly from around 20 percent in 2010 to 40 percent at end-2014, but has since risen more modestly to 49 percent in 2017. Credit remains concentrated in services (including construction of public infrastructure and manufacturing facilities), industry, and commerce. The loan-to-deposit ratio rose to 98.5 percent at Q3:2017, but reached 103 percent for loans in kip as banks have increasingly accessed foreign borrowing to finance credit. Consistent with moderate financial deepening, overall private credit growth is projected to remain at 17 percent in 2018, reflecting robust FDI, but moderate demand from the public sector.





5. External sector vulnerabilities remain high, but are being ameliorated. The current account deficit narrowed in 2016, due to higher electricity and manufacturing exports, but at an estimated 13 percent of GDP in 2017 is still high. International reserves are expected to remain well below recommended levels at around 1 month of imports in the IMF's calculation (which does not adjust for FDI-related imports)[3], around 16 percent of foreign currency liabilities in banks, and 21 percent of foreign-currency deposits. Over the next three years, construction of the Kunming-Vientiane railway will generate a widening in the current account deficit, but this will be reversed in the medium-term as project-related imports fall and electricity exports come on line. Gross international reserves are expected to remain low at around 1.5–2 months of imports due to anemic productivity growth and slow progress on economic diversification.

[3] The authorities exclude a measure of FDI-related imports from the calculation which results in an estimated reserve adequacy of about 4 months of non-FDI-related imports.

6. External sector assessment (Appendix I). Based on the IMF's External Balance Assessment Lite methodology, the external position at end-2016 is assessed to be substantially weaker than implied by fundamentals and desirable policies, although there are several factors that mitigate risks. At end-2016, the kip was assessed to be overvalued by around 44–49 percent which, given the managed exchange rate regime, calls for a continued gradual depreciation of the nominal exchange rate, and policies to consolidate the fiscal position and improve productivity over the medium-term. There is also an urgent need to increase reserve coverage. Although the presence of large flows of foreign direct investment and dollar denominated trade contracts lessens the vulnerabaility of the current account to external shocks, staff estimates that the non-FDI related trade deficit is still high at 7.6 percent of GDP for 2017.

Lao P.D.R: External Balance Assessment (Lite)

Real Exchange Rate Gap	
Current account approach	43.7%
REER approach	49.4%
Current account	
Actual current account	-11.9%
Current account norm	-1.3%
Current account gap	-10.7%
o/w policy gap	-14.1%
Elasticity of current account	-0.24

Source: IMF Staff.

7. The baseline outlook is subject to a number of risks (Appendix II):

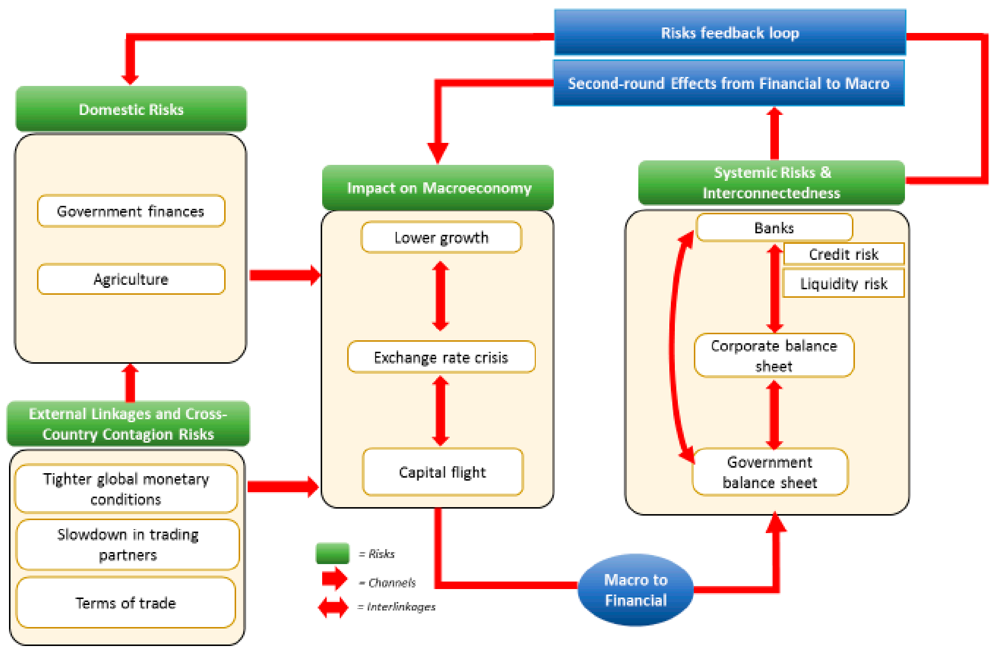
- **Domestic risks**
  - ***Government finances.*** A failure to contain the fiscal deficit would worsen an already weak external position and, given the high level of the public debt stock, increase the possibility of debt distress, higher interest rates, lower external financing and a slow-down in growth.
  - ***Agriculture.*** One-sixth of the total economy is in agriculture, and an extreme weather shock would damage growth prospects, worsen the current account, and risk hurting the rural population, reversing poverty reduction.
- **External risks**
  - ***Global monetary conditions***. Tighter global monetary conditions could raise funding costs, hurt domestic liquidity in the dollarized banking system increasingly reliant on external funding, and lead to a reduction in credit.
  - ***Capital flight or deterioration in terms of trade.*** With a thin reserves cushion, the external position remains vulnerable to a deterioration in the terms of trade or sudden capital flight, which could cause a deterioration in confidence in the financial system.
  - ***Slowdown in trading partners.*** A significant slowdown in China would impact commodity and agriculture exports and tourist arrivals, and could be felt in Lao P.D.R. through lower foreign direct investment (China is the main source of FDI), and capital flow reversal.
- **Macrofinancial risks**

- ***Banking system liquidity crunch:*** A sudden tightening of liquidity due to banking system distress could cause a credit crunch and a slowdown in economic activity, with adverse feedback loops through further distress in bank and corporate balance sheets.

- ***Banking system solvency:*** A macroeconomic or external shock that leads to a sudden slow down in economic activity could lead to higher non-performing loans and expose weaknesses in the banking system that could lead to further declines in credit and slower growth.

- ***Exchange rate:*** A sudden devaluation of the exchange rate could lead to a rapid deterioration in the balance sheets of banks and corporates with currency mismatches, which could affect banking system liquidity and solvency and lead to a further decline in credit and economic activity.

Lao P.D.R.: Macro-Financial Linkages



Source: IMF Staff.

8. **An adjustment scenario including recommended policies would result in lower growth in the near term, but more robust and sustainable growth over the medium-term.** The economy would also become more resilient to external shocks and allow a rebuilding of policy buffers, including lower public debt, a smaller current account deficit and higher reserves (Box 1).

Authorities' Views

9. **The authorities broadly shared staff's assessment of the outlook and risks.** They acknowledged the macrofinancial risks related to the external sector and the effect of a large devaluation on the balance sheets of banks and corporates. For this reason, they opted to allow the exchange rate to move only gradually within its band. Nevertheless, they argued that the banking system is largely well capitalized and could withstand a significant shock without sparking a systemic

crisis. The authorities also pointed out that the overvaluation of the exchange rate had been mitigated during the course of 2017 with the dollar depreciating against Lao P.D.R.'s major trading partners.

Box 1. Adjustment Scenario

The adjustment scenario is based on the following assumptions:

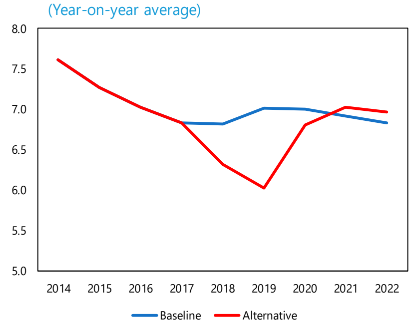
- **Begin multi-year fiscal consolidation**. Implement tax revenue measures while containing public sector wage growth (link salaries to inflation and keep the headcount constant) to bring the fiscal deficit to 2.6 percent of GDP on average, sufficient to lower the debt to GDP ratio to 50 percent by 2022.
- **Gradual exchange rate adjustment**. Use full flexibility in current exchange rate regime to adjust by 27 percent over 5 years, via nominal depreciation and productivity growth, to help realign the REER with fundamentals.
- **Banking sector reforms**. Strengthen management of state-owned banks.
- **Structural reforms to boost competitiveness and long-term productivity**

Macro Framework Under Adjustment Scenario

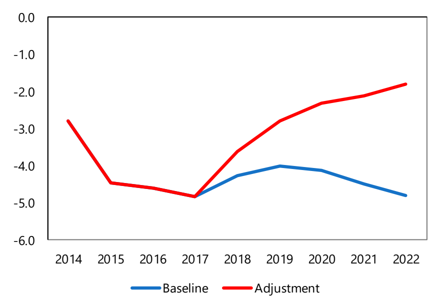
	Actual	Proj.	Alternative Scenario Projections				
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Real GDP	7.0	6.8	6.3	6.0	6.8	7.0	7.0
Current account (percent of GDP)	-12.0	-13.0	-10.6	-9.3	-8.3	-7.8	-7.6
Fiscal deficit (percent of GDP)	-4.6	-4.8	-3.6	-2.8	-2.3	-2.1	-1.8
Public debt (percent of GDP)	58.5	60.1	59.9	57.1	54.5	52.2	50.0
Reserves (months of imports)	1.2	1.3	1.4	2.0	2.5	3.3	4.0

Source: IMF staff projections. The fiscal multiplier is assumed to equal 1, and the exchange rate-current account elasticity is 0.47. The exchange rate-inflation pass-through is estimated to be negligible in Lao at around 0.2. The impact of a multi-year fiscal consolidation on real output is undertaken as in Bi, R., H. Qu and J. Roaf (2013), 'Assessing the Impact and Phasing of Multi-year Fiscal Adjustment: A General Framework', IMF Working Paper, WP/13/182.

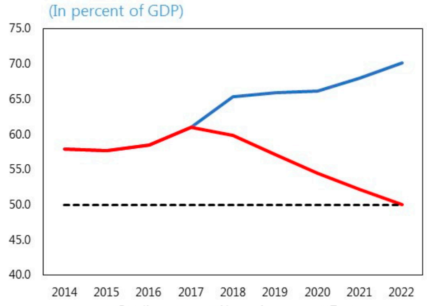
Real GDP Growth
(Year-on-year average)



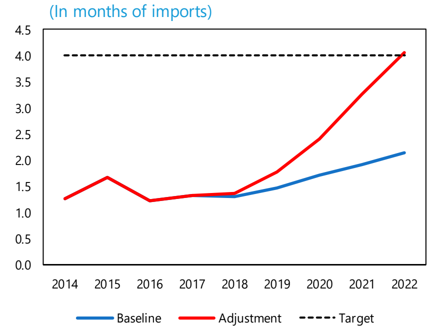
Fiscal Deficit
(In percent of GDP)



Public debt
(In percent of GDP)



Foreign Reserves
(In months of imports)



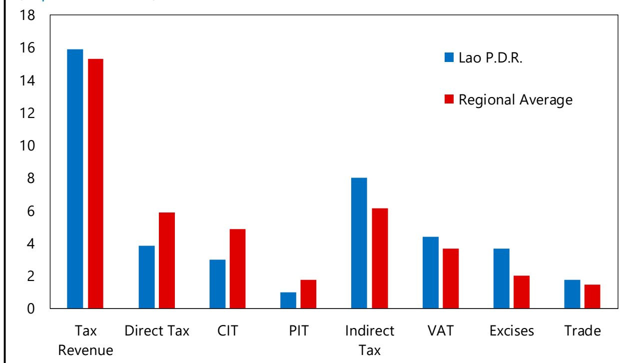
Source: IMF Staff.

POLICY DISCUSSIONS

A. Putting Debt on a Sustainable Path While Meeting Development Needs

10. The fiscal outturn in 2017 was less favorable than expected. The fiscal deficit is expected to widen from 4.6 percent of GDP in 2016 to 4.8 percent of GDP in 2017, mainly due to underperformance of tax revenues and increases in capital spending. Overall revenue is expected to rise to around 17 percent of GDP, due to an increase in non-tax revenues and grants, but tax revenue is expected to remain flat at 12.3 percent of GDP. Current expenditure is expected to fall despite an increase in the wage bill, but capital spending is expected to rise relative to 2016, as government investment gradually resumes its historical level.

Lao PDR: Tax Structure Compared to Regional Average
(In percent of GDP)



Source: IMF Staff Estimates.

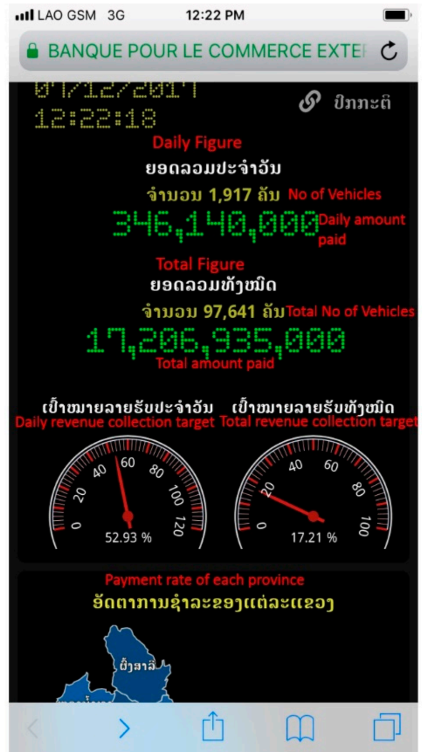
11. Public debt remains elevated. The Debt Sustainability Analysis puts the public and publicly guaranteed (PPG) external debt at high risk of debt distress, despite the rebasing of GDP, which lowered ratios compared to last year. Much of the debt is denominated in foreign currency (80 percent), and although over 85 percent of external debt is on concessional terms, a decline in fiscal revenues led the external debt service to revenue ratio to breach the DSA threshold. Based on current policies, the debt-to-GDP ratio is expected to rise to 70 percent of GDP by 2022 (high by frontier market standards), with debt increasingly contracted on non-concessional terms. The recognition of government arrears to construction companies from cancelled public investment projects is expected to add about 2 percent of GDP to the debt ratio in 2018.

12. Staff's baseline scenario projects improvement, as the authorities are poised to make changes in tax administration and policy. The authorities intend to better administer the profit and lump sum taxes (with an increase in the limit for SMEs), and to channel payment of taxes through the banking system to reduce leakages and broaden the tax base (Box 2). In addition, the authorities plan to increase the excise tax on fuels and implement a specific tax on alcohol. Some of these improvements will be counteracted by declines in VAT revenue from a better administration of the refund. On the expenditure side, the authorities plan to keep the wage bill fixed in nominal terms in 2018. Under this scenario, the deficit would fall to around 4 percent of GDP in 2018–19, but rise to around 5 percent of GDP in the medium-term as mining revenues decline and excise tax revenue moderates due to the ASEAN tariff reduction schedule.

Box 2. Fintech Comes Through the Budget

Owners of private motor vehicles in Laos must pay an annual road tax that goes into general government revenue. The Tax Department estimates there are about 1.8 million taxable vehicles in the Lao P.D.R. In the past 5 years, the average annual collection of road tax was around Kip 10 billion.

To improve compliance, the government partnered with the largest commercial bank—state-owned BCEL—to roll out an App in November 2017 to greatly simplify road tax payments. The App facilitates payments, but also displays real-time information on road tax collection and the number of vehicles that have paid by province. This will allow the government to build a province-level data base to check registered vehicles that have not paid the road tax. Between November 2017 and end-January 2018, road tax collections reached around Kip 36 billion (almost four times the previous annual figure), and are expected to reach Kip 60 billion by April 2018, the deadline for paying the 2017 road tax. The road tax App exemplifies the government's effort to modernize tax administration and bring tax payments into the banking system to reduce revenue leakage.



Source: Lao P.D.R. Authorities.

13. To reduce debt vulnerabilities and maintain a pattern of expenditure that will support graduation from LDC status, further reforms are needed. With these reforms, the authorities should be able to reduce the fiscal deficit in line with the adjustment scenario (Box 1):

- ***Establish a public debt anchor.*** Given the deterioration in the deficit and high debt in 2017, the authorities should anchor fiscal policy on reaching an overall public debt ratio (external and domestic public and publicly guaranteed) of 50 percent of GDP by 2022, a level consistent with low risk of debt distress under the current DSA.[4] This will require maintaining an average overall deficit of 2.6 percent of GDP during 2018–2022.

[4] Under this alternative scenario, the domestic debt to GDP ratio remains broadly stable (in line with the authorities' intention to develop the local debt market) and the external public and publicly guaranteed (PPG) debt is reduced, resulting in an overall public debt ratio of 50 percent of GDP. The reduction of PPG external debt would lead to a low risk of debt distress with all debt indicators below their relevant thresholds, including under stress tests. For an overall debt target of 55 percent of GDP some indicators would breach the indicative threshold under the most extreme stress test.

- ***Short term revenue policies.*** Continued robust growth will present a good environment to begin implementing tax reforms, in line with technical assistance advice. Text Table 1 presents some suggestions for short-term tax reform that could result in significant additional revenue. The authorities have already signaled they could implement some of these measures (particularly excise taxes on alcohol).[5]

Short-Term Tax Reform Priorities

Profit Tax
Reintroduce tax on capital gains on the disposition of tangible capital assets.
Lump-Sum Tax
Simplify the LST to apply a uniform-rate turnover tax to businesses below the VAT threshold; set rate to increase revenue by 0.2% of GDP.
Excises
Switch from ad valorem to specific excises on fuel and Increase rates on gasoline and diesel by $0.03 - $0.05/Liter relative to current level.
Subject alcoholic drinks to specific excises proportional to the alcohol content of each group of drinks.
Subject tobacco products to specific excises proportional to tobacco content and increase overall effective rates to replace revenue from repeal of profit tax surcharge
Land Tax
Restore the real value of fees per hectare or square meter by indexing for cumulative inflation since the last time they were set.

- ***Short-term expenditure policies***. The authorities indicated they would maintain the public wage bill fixed in nominal terms in 2018 by not adjusting the wage index and allowing the civil service head count to decline through attrition. Going forward, keeping the rise in the index at the rate of inflation will help the government reach its target of limiting wage expenditures to 40 percent of revenue (45 percent of revenue in 2017), an adjustment of about 0.5 percent of GDP in current expenditure per year on average over the medium-term.[6]

- ***Reform tax exemptions.*** The authorities have made an effort to better administer tax exemptions, particularly for the import of petroleum products. However, to better understand the revenue loss from exemptions and evaluate their costs and benefits the government should implement a tax expenditure review. Tax holidays should be

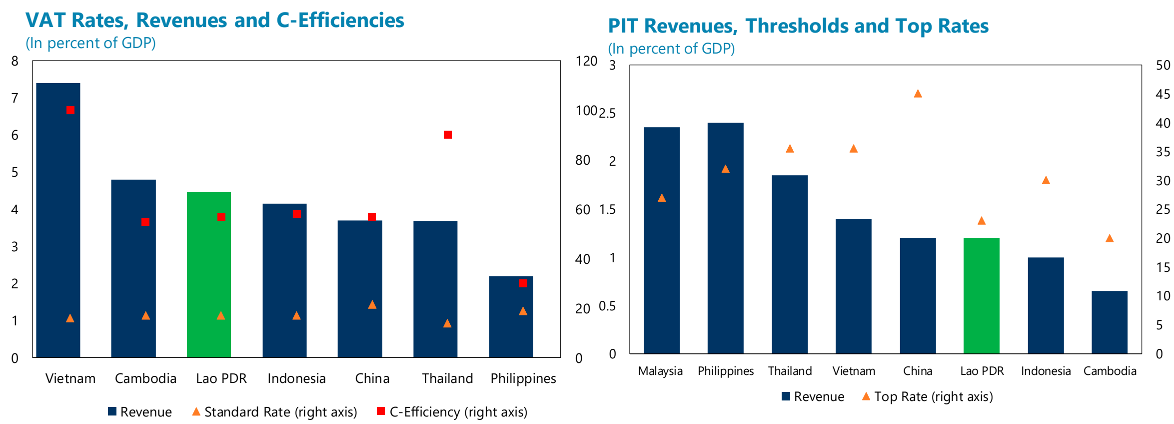
[5] This table is based on information gathered from recent technical assistance on tax policy reform. Due to a lack of data, staff is unable to make precise estimates of revenue gains from these reforms. Current technical assistance in tax administration, as well as a medium-term revenue strategy (MTRS) mentioned below, would aim to quantify the gains from these reforms and others.

[6] This is compared to a scenario where the public wage bill remains constant as a percent of GDP.

discontinued, and incentives limited to investment, while customs incentives should be limited to firms in special economic zones that can be effectively monitored.

- ***Medium-term Revenue Strategy (MTRS).*** Further revenue gains will be needed to increase space for priority spending in health, education and infrastructure while achieving a gradual fiscal consolidation. The government has expressed interest in developing a medium-term revenue strategy (MTRS) in 2018 with the help of IMF technical assistance, which would lay out an agenda and quantify the benefits of tax administration and tax policy reforms. An MTRS would allow greater coordination of efforts already under way and a consistent plan for how to continue the reform between 2018 and 2022.

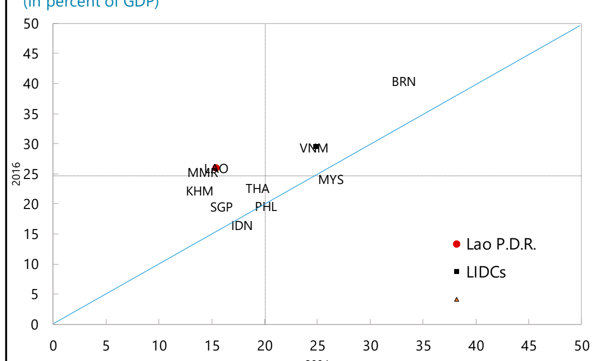
Lao P.D.R.: Tax Code Needs to Be Simplified and Exemptions Reduced



Source: Authorities' data and IMF Staff Estimates.

- ***Public Expenditure Reform.*** Over the past decade overall public spending has increased more rapidly in Lao P.D.R. compared to regional peers, yet spending on social assistance is lower, and the public-sector wage bill is among the highest (Figure 4 and 5). Health and education outcomes are also below regional averages. There is a need to reorient spending towards improvements in health and education. At the same time, public investment has been volatile as the government has attempted to deal with poor coordination between central and local authorities and governance issues in part by closing investment projects and settling arrears. To improve the efficiency and transparency of public expenditure the authorities could pursue a Public Investment

Lao PDR: General Government Spending 1/
(In percent of GDP)



Source: IMF FAD Expenditure Assessment Tool (EAT), World Economic Outlook.
1/ Dashlines are the average of ASEAN.

Management Assessment (PIMA) to benchmark Lao P.D.R. against its peers, bearing in mind that Lao P.D.R. is ranked low (123) on Transparency International's corruption perception index.

Authorities' Views

14. Although they have no official debt target, the authorities agreed that a debt ratio of 50 percent of GDP was a safe level, and that further reforms were needed to reduce the deficit and bring down the public debt ratio. However, they emphasized the pace of consolidation was likely to be slower than staff recommended and reaching a public debt ratio of 55 percent of GDP by 2022 was more realistic. Tax policy and administration reforms were likely to require significant improvements in data gathering and revisions to tax laws in 2018–19, and the fruits of these efforts were not likely to be seen earlier than 2019–20. The authorities agreed with the goal of better targeting investment and social spending, and had already moved to better control public investments projects. The high level of debt was recognized as a concern and the government plans to institute reforms under the new Public Debt Management Law and the new Public Procurement Law to put a limit on annual borrowing and restrict new debt to (expected in 2018) concessional terms, as well as establishing an official medium-term target.

B. Safeguarding Macro-Financial Stability and Fostering Financial Market Development

Monetary and Exchange Rate Policy

15. Monetary and exchange rate developments. As of the third quarter of 2017, banking system excess reserves remained high at 7 percent of GDP, reflecting bank preferences for precautionary balances in the absence of a functioning interbank market. Dollarization has been persistent, and since the introduction of a cap on interest rates for kip-denominated loans in 2015, foreign currency credit growth has outstripped kip lending growth, increasing the risk of re-dollarization and growing balance sheet mismatches.[7] The increase in dollar lending in recent years has mirrored a decline in commercial bank NFA, suggesting that credit is being increasingly financed by external non-core sources, mainly regional banks and particularly from China. The Bank of Lao P.D.R. (BOL) has allowed the kip to depreciate gradually by about 2 percent during 2017.

16. Policy recommendations. While maintaining a managed and gradually depreciating exchange rate in the near term, the authorities should work to reform the monetary policy regime, to allow the introduction of more exchange rate flexibility in the medium-term and support de-dollarization.

[7] Mismatches are currently estimated conservatively at around 4.5–5 percent of GDP for the bank and non-bank private sectors.

17. Short-term priorities include:

- ***Exchange rate policy and reserves***. Continue to use the flexibility in the current regime (plus or minus 5 percent per year) to allow the currency to depreciate gradually when necessary, and tighten fiscal and monetary policies to support a buildup of reserves to at least 4 months of import cover (excluding the adjustment for FDI related imports). Given the existence of currency mismatches on corporate, bank and public sector balance sheets it is not advisable to implement a more aggressive exchange rate adjustment in the near term.

- ***Developing market infrastructure.*** The implementation of a new Law on the Payment System is welcome and will help clarify the legal framework for payments and facilitate development of local markets. In addition, to develop the local debt market, a first step is to issue government securities on a regular basis with an advance auction to develop a benchmark yield curve. Developing the Lao Securities Exchange platform to enable electronic trading of dematerialized securities will also help develop market liquidity.

- ***Removing interest rate caps.*** The interest rate cap on kip deposits and lending is a market distorting measure that encourages dollarization and discourages lending to SMEs. Removing the cap on kip interest rates will allow banks to set interest rates to adequately price the additional risk of lending to SMEs, and will also allow banks to offer higher interest rates on deposits to attract kip liquidity, which is scarce for some banks.

18. In the medium-term it will be important to continue to develop the monetary policy framework to allow greater exchange rate flexibility. In line with past advice, the Bank of Lao P.D.R. (BOL) should work toward establishing an alternative nominal anchor for monetary policy, to allow for a more flexible exchange rate over the medium-term, help promote economic diversification and growth, and insulate the economy from external shocks.

Authorities' Views

19. The authorities agreed on the need to increase the level of gross international reserves while noting challenges due to a scarcity of foreign exchange in the economy, partly related to the fact that large FDI projects in hydropower and mining were allowed to keep their foreign exchange earnings outside the country. The authorities also agreed that greater exchange rate flexibility was desirable in the medium-term and noted they were working to develop market infrastructure, particularly the legal framework (with new laws governing the Central Bank and Commercial Banks and the Payments System expected to be passed by the National Assembly in 2018) and payments system infrastructure. This should help bring transactions into the banking system, increasing transparency and encouraging the use of local currency. The authorities explained that the interest rate cap was imposed in response to a perceived lack of competition in the banking system, and they planned to wait until the interbank market was more developed to remove them.

Strengthening the Banking System

20. Asset quality issues, thin capital buffers, and weak profitability continue to weigh on parts of the banking system. While the system-wide capital adequacy ratio appears to be above the Basel I minimum of 8 percent, capital in some state-owned and joint-venture banks is likely below the minimum. Weak application of accounting standards mean the level of NPLs is likely understated, and the small increase in credit costs since 2013 suggests that banks have under-provisioned for potential losses.

21. The authorities have been working on improvements in regulation and supervision, bank restructuring, and the AML/CFT framework. Progress has been made in developing risk based supervision procedures and manuals, and to transition toward the Basel II framework, which will require further capital buffers. The authorities are currently working on restructuring two state-owned banks (about 10 percent of system assets) and have partially recapitalized the largest state-owned bank (BCEL – 28 percent of system assets). Lao P.D.R. also recently graduated from the Financial Action Task Force (FATF) grey list, and is implementing a new AML/CFT law to better align to the revised FATF standards.

22. The authorities plan to help commercial banks by assuming debts related to public infrastructure projects. The Ministry of Finance plans to allow banks to exchange up to 3,200 billion kip (2.1 percent of 2018 GDP) of loans for 10-year government bonds. The total of these loans, which are recognized to be related to legitimate contracts, amount to about 5 percent of the loan book to the private sector. The bonds will carry a 5 percent coupon, and the amortization of the bonds, in equal annual installments over 10 years, will be financed from the capital expenditure budget. Given that these projects were viewed as implicitly guaranteed by government, and that most lending was undertaken by public banks, it is reasonable for the government to seek to recognize these arrears, although they will add to the public domestic debt. The removal of these loans should help strengthen bank balance sheets.

23. To continue the process of financial deepening, strengthen resilience to foreign and domestic risks and reduce dollarization (Appendix III), staff recommends the following reforms:

- ***Reduce foreign currency lending risks.*** In addition to limits in place on banks' net open positions, additional measures to reduce potential currency mismatches, increase local currency use, and bolster financial sector resilience include:
  - Tightening macroprudential policy by raising foreign exchange reserve requirements, which will also act as a liquidity buffer that can be used in the event of a sudden tightening in liquidity;
  - Increasing capital buffers and provisioning and higher liquidity requirements for high foreign exchange credit exposures;

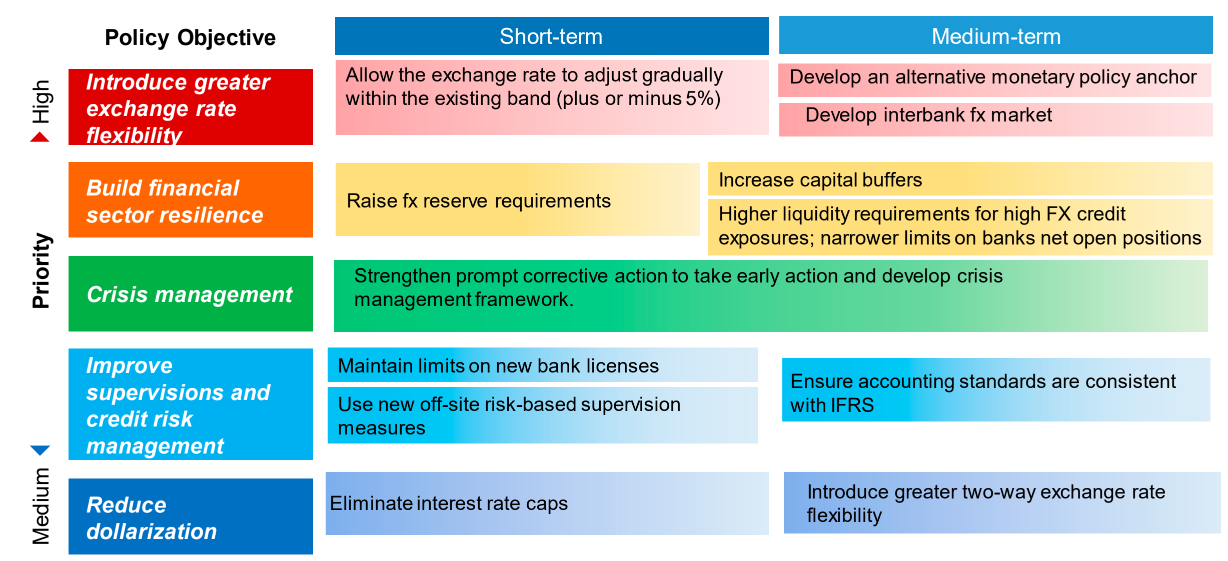
- ➢ Requiring all government transactions to be based in kip, and introducing market-based policies to improve local currency attractiveness, such as ensuring convenient payment methods;

- ➢ Gradually introducing greater two-way flexibility in the exchange rate to strengthen incentives to avoid currency mismatch risks.

- ***Strengthen financial sector buffers.*** NPLs should be identified through due diligence with the help of independent audits as needed, and provisions increased where necessary. Forbearance on compliance with the mandatory minimum CAR of 8 percent should be eliminated.

- ***Continue improving supervision and credit risk management.*** The increased use of risk-based supervision is welcome, and the BOL should continue to move towards full implementation. To improve credit risk management the authorities should also focus on supervising related-party lending and large exposures to align with international best practice, and conduct regular validation exercises to ensure accurate reporting as mandated in the 2013 Law on Accounting in line with IFRS.

Lao P.D.R.: Sequencing of Policy Recommendations for Exchange Rate Reform



* Measures: Macro-prudential measures

- ***Develop the crisis management and prompt corrective action framework***. To complement the move towards risk-based supervision, a Prompt Corrective Action Framework should be devised alongside a Crisis Management Framework, which should have explicit interagency coordination mechanisms, an emergency liquidity assistance framework with appropriate safeguards, and a communications strategy.

Authorities' Views

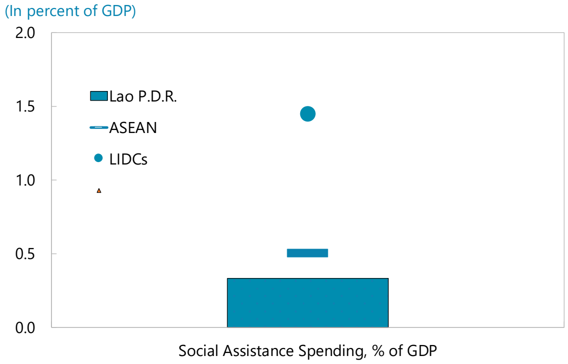
24. The authorities noted that the policy recommendations were in line with plans and actions already in train to improve the resilience of the banking system, particularly through the implementation of risk based supervision, the introduction of Basel II standards, public bank restructuring and the assumption of debts related to cancelled infrastructure projects. In addition, they highlighted the new Commercial Bank Law, expected to be passed by the National Assembly in 2018, contains provisions for crisis management and bank resolution. The authorities planned to develop financial soundness indicators to better track developments in the banking system in 2018, and to conduct a national risk assessment for the AML/CFT framework in 2019 in preparation for an AML/CFT evaluation under the revised FATF standards planned for 2020.

C. Promoting Competitiveness and Inclusive Growth

25. Improving the framework for public and private investment. Lao P.D.R. is a land-locked country, and infrastructure needs have been estimated at around 14 percent of GDP. To promote private participation, it will be important to continue development of the legal framework for public private partnerships (PPPs), which will be included in the new Public Debt Management Law. A Public Investment Management Assessment (PIMA) would also be useful to set priorities for public investment reform. Improving the environment for private investment will also be key. In this connection, the government is focused on improving indicators for ease of doing business, and Small Medium Sized Enterprises (SME) development. Reforming and simplifying the tax code and facilitating tax compliance should contribute to improve the business climate.

26. Promoting inclusive growth. Lao P.D.R.'s impressive growth has been accompanied by rising income inequality and persistent gender disparities (Figure 10). The labor force participation rate has been falling for both men and women, which could be explained by the pattern of development, based on capital- and natural resource-intensive investments, that has not produced enough formal employment to keep up with entrants into the labor force. However, female labor force participation has not fallen as fast, and from 2010 female labor force participation was higher than male labor force participation. This is most likely due to:

Lao PDR: Social Assistance Spending
(In percent of GDP)



Sources: IMF FAD Expenditure Assessment Tool (EAT), World Economic Outlook, ASPIRE, and IMF Pension Indicators.

- Migration of men to neighboring countries where there are employment opportunities at much higher wages. The possibilities of mobility for women are much more restricted;

- The fact that the majority of the population remains in rural areas where female labor force participation is higher, related to unpaid work on family-run farms;

- The predominance of women in low-skilled services (trade and hospitality, for example) that have been an important driver of employment growth recently in Lao P.D.R.

Women are thus concentrated in low-skilled and low-productivity employment, a fact which reflects gender disparities in access to education, health and other services. This also leads to a concentration of women workers in the informal sectors. Raising human capital, especially among women and poorer households, and increasing connectivity through infrastructure investments, will thus be critical to promote sustainable and inclusive growth, improve productivity and promote diversification as Lao P.D.R. integrates into the larger ASEAN economy

27. Improving statistics. Weak data impose significant constraints on policymaking in Lao P.D.R., particularly in the external sector, fiscal accounts and banking system. The authorities have expressed an interest in joining the IMF's Enhanced General Data Dissemination Standard (e-GDDS) and taken up technical assistance in balance of payments compilation, national accounts and fiscal accounting, and improvements are expected.

Authorities' Views

28. The authorities recognize the importance of improving the environment for private investment, and noted that the 8th National Socio-Economic Development Plan 2016–2020 (NSEDP) focuses on the non-resource private sector (especially SMEs), and improving human capital through education and health to compete more effectively within the gradual integration in the ASEAN Economic Community. They also noted that in 2018 there would be a focus on improving the financial performance of key state owned companies (including Electricite du Laos (EDL) and Lao Airlines) with possible equitization. Inclusive growth was also one of the main goals of the 8th NSEDP, which has explicitly integrated the SDGs (see Box 3) with specific targets set by the National Assembly for spending on health and education in 2018.

Box 3. Welfare and the Sustainable Development Goals

While per capita income has risen rapidly, a consumption equivalent welfare measure has not kept pace. This is due mainly to a focus on investment-led growth, lower life expectancy and the costs of deforestation. The authorities' focus on integrating the SDGs into development planning augurs well for a correction of these trends going forward.

Lao P.D.R.'s focus on meeting the SDGs illustrates the authorities' goal of improving economic welfare, social inclusion and environmental sustainability. Lao P.D.R. has integrated the SDGs into its 8th National Social Economic Development Plan (NSEDP for 2016-2020) through a consultative process, including academia, civil society, government agencies, the private sector and development partners. As a result, around 60 percent of the monitoring and evaluation indicators in the 8th NSEDP are explicitly linked to the SDGs, covering most areas of social wellbeing and environmental action. In addition, Laos has designated the removal of unexploded ordinance (UXO) as an additional goal.

Laos will present its voluntary national report (VNR) on progress in implementing the SDGs at the UN high-level political forum (HLPLF) in July 2018. This report will allow Laos to share its experiences, progress and challenges in implementing its SDGs, and will inform the overall review of progress on the Agenda 2030 for Sustainable Development.

A key challenge for Laos's implementation of the SDGs is the quality of data to monitor progress. While data for basic economic analysis are adequate, many detailed indicators needed to monitor the full range of the SDGs are either of poor quality or do not exist. Data quality issues are compounded at the provincial level.

Table 1: Indicators of Welfare, 2014

Indicator	SDGs	Lao PDR	ASEAN	U.S.	World 1/
Life expectancy (years)	3	66.1	72.4	78.9	71.7
Real consumption (percent of U.S. income)	1, 2, 3	8.0	18.7	83.0	25.5
Real consumption (percent of income)	1, 2, 3	72.5	71.7	83.0	81.1
Annual hours worked per capita	3, 8	870.4	1132.7	820.1	753.0
Inequality (Gini coeff.)	10	37.9	40.0	35.2	36.5
GHG emissions per unit of consumption	13, 14, 15	0.62	0.13	0.01	0.07
GDP per capita (percent of US)		11.0	31.8	100.0	36.8
Welfare per capita (percent of the US) 2/		2.5	17.3	100.0	30.6

1/ Sample of 150 countries.
2/ Consumption equivalent welfare calculations; Bannister and Mourmouras (2017).

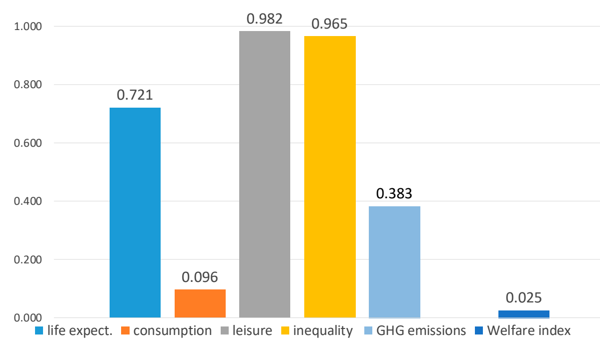
As is well-known, the dimensions of well-being codified in the SDGs go well beyond GDP and are difficult to quantify with traditional economic statistics. For example, although Lao P.D.R. has enjoyed growth in real GDP per capita of over 5 percent per year in the last 20 years, inequality has risen and growth has been associated with the depletion of natural resources.

To quantify these trade-offs, staff use an index of consumption equivalent welfare.[1] This index aggregates indicators linked to the SDGs in an economically consistent way by measuring their impact on consumption-equivalent welfare. The components of the index (life expectancy, real consumption, hours worked/leisure, inequality and green-house gas equivalent (GHG) emissions) encompass the core SDGs.

Box 3. Welfare and the Sustainable Development Goals (concluded)

The index calculations reveal how the pattern of growth in Laos has had implications for welfare (Table 1). While per capita income in Laos has grown rapidly to reach 11 percent of the U.S. level in 2014, consumption equivalent welfare was only 2.5 percent of the U.S. level, as a result of lower life expectancy, lower consumption and leisure, and higher inequality and GHG emissions. Consumption in particular is not only low in proportion to US income (8 percent), but also in proportion to Laos' own level of income (at 73 percent), a feature that Laos' shares with some other ASEAN economies and China, reflecting a focus on capital intensive investment-led growth which limits the distribution of benefits. GHG equivalent emissions are also high in Laos relative to other countries, reflecting the cost of deforestation. The components of the index enter into the calculation in a multiplicative manner (Chart 1). Consumption and GHG emissions are the two elements that are most binding in the welfare calculation, followed by life expectancy.[2]

Lao PDR: Components of the Welfare Index



The welfare calculation illustrates how structural reforms are necessary to secure more sustainable and inclusive growth in line with the SDGs. Reforms to promote diversification of the productive base and facilitate private economic activity will create opportunities for more productive employment and reduce rural/urban and gender inequality. These include infrastructure investments, reform to the business environment to promote SMEs, training and education, and investments in health, especially for children and women. In addition, the ongoing efforts of the authorities to more tightly regulate illegal logging and mining activities will help secure environmental sustainability.

1/ Charles I. Jones and Peter J. Klenow, "Beyond GDP? Welfare across Countries and Time" American Economic Review 2016, 106 (9) 2426-2457, and Geoffrey J. Bannister and Alexandros Mourmouras, "Welfare vs. Income Convergence and Environmental Externalities" (IMF working paper WP/17/271).

2/ A level of 1 represents the maximum attainable for each components and for the index.

STAFF APPRAISAL

29. Lao P.D.R. has charted a plan for reform to address its vulnerabilities and development challenges. Growth has slowed slightly, in part because the government has begun to address issues of illegal logging and rationalize public investment, but is expected to remain robust in the medium-term. Inflation remains low, anchored by the tightly managed exchange rate, even though there has been a moderate depreciation over the last 12 months. The government recognizes the high level of public debt as a key concern, and is moving to implement revenue and expenditure reforms. It has also moved to reduce vulnerabilities in the banking system through better regulation and supervision and recapitalization/restructuring of public banks. It has integrated the Sustainable Development Goals into its 8th five-year plan (2016–2020) to promote more inclusive and environmentally friendly growth.

30. A transition to more sustainable and inclusive growth will require further reforms to address risks. Under staff's baseline scenario the economy continues to be subject to fiscal risks and potential debt distress, and a deterioration of the external environment could lead to tighter financial conditions, a slowdown in external financing, and lower growth that could put further pressure on debt sustainability. In addition, macro-financial feedback loops between lower growth, external shocks, the exchange rate, fiscal revenues and bank and corporate balance sheets, could exacerbate the impact on growth, financial conditions, public debt and poverty.

31. To remove the risk of debt distress, debt should be anchored on a ratio of 50 percent of GDP and a gradual fiscal consolidation resumed. Short-term revenue and expenditure policies and a reform of exemptions could begin to contain the fiscal deficit while a medium-term revenue strategy is designed, oriented at bringing the fiscal deficit down to an average of 2.6 percent of GDP over the next 5 years. At the same time, changing the mix of public expenditures towards investment and social spending would help improve health and education outcomes. A PIMA could help establish priorities for public investment reforms. Staff welcomes authorities' efforts to settle past investment arrears, better manage public investment projects and debt under the new Public Debt Management Law and initiatives to reduce leakages and better administer the tax regime.

32. The external position is vulnerable, underscoring the need for fiscal consolidation and allowing greater exchange rate flexibility over the medium-term. In the near term, using the flexibility afforded under the 5-percent band will help regain competitiveness and accumulate reserves, and removing interest rate caps will improve the allocation of credit. Ongoing efforts to develop the payments system are welcome, but further reforms are needed to improve the functioning of the interbank and local debt markets. These are important steps in the process of moving towards an alternative anchor for inflation which, together with efforts to address currency mismatches in corporate and bank balance sheets, should allow greater exchange rate flexibility in the future.

33. Progress has been made in strengthening banking regulation and supervision, and reform of public banks, but vulnerabilities remain. The removal of doubtful loans related to cancelled infrastructure projects that amount to five percent of the loan book should help significantly strengthen bank balance sheets. However, further efforts are needed to reduce foreign currency lending risks, identify NPLs and strengthen capital buffers. Staff welcomes the new Central Bank Law and Commercial Bank Law that will put in place crisis management and prompt corrective action frameworks, and progress in developing the AML/CFT framework.

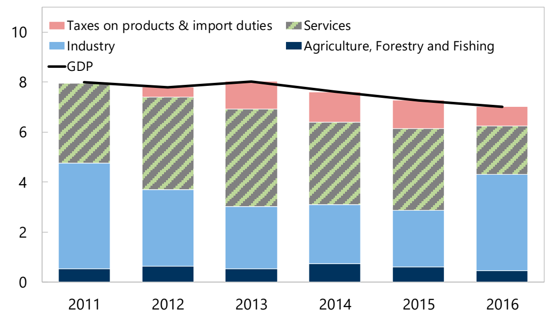
34. The gap between income per capita and welfare indicators illustrates the need to pursue policies for more inclusive and sustainable growth (Box 3). Promoting economic diversification and investing in human capital are key. Developing public infrastructure and putting in place better conditions for private investment will contribute to these ends. In addition, improving public education and health services, particularly for women and children, will help support growth while reducing regional and gender inequality. Finally, improving statistics will be important to support economic policy and attaining the SDGs. Staff welcomes the authorities interest in joining the e-GDDS.

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

Figure 1. Lao P.D.R.: Growth Remains Robust and Inflation is Contained

Real GDP growth remained at 7 percent, supported by services…

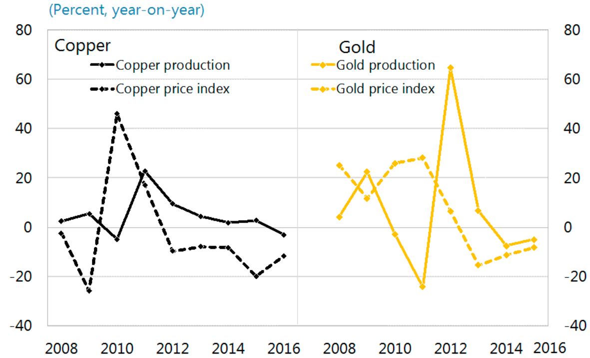
Contribution to Growth: by Industry
(In Percent)



Sources: National Authorities; and IMF staff calculations.

…along with mining production and a pickup in commodity prices.

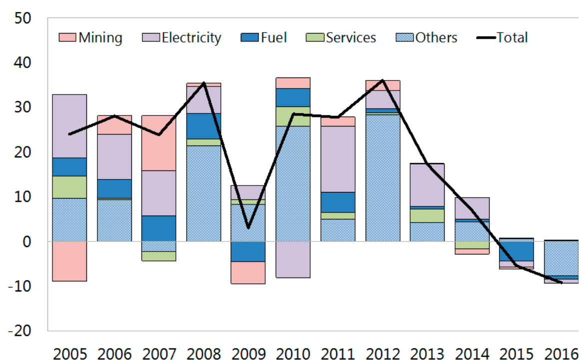
Mining Production
(Percent, year-on-year)



Sources: National Authorities, and IMF staff calculations.

Imports data indicate investment and consumption activity continued tapering off in 2016…

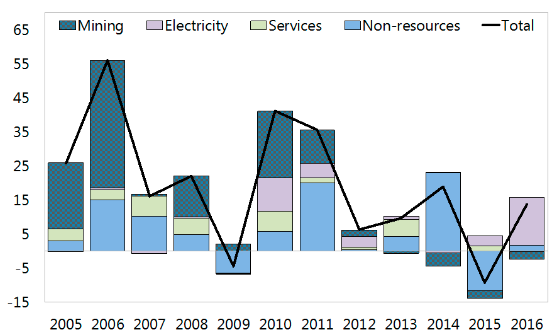
Contribution to Import Growth
(Percentage points)



Sources: National authorities; and IMF staff calcualtions.

…while electricity exports helped support export growth

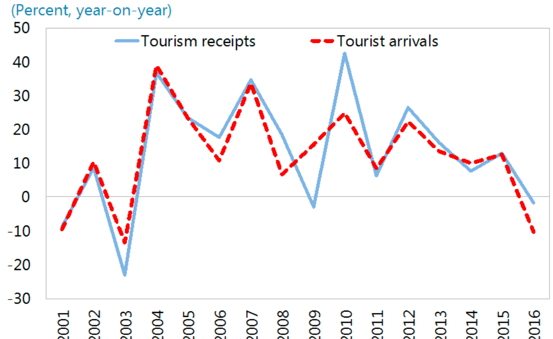
Contribution to Export Growth
(Percentage points)



Sources: National authorities; and IMF staff calcualtions.

Tourism activity remained sluggish in 2016.

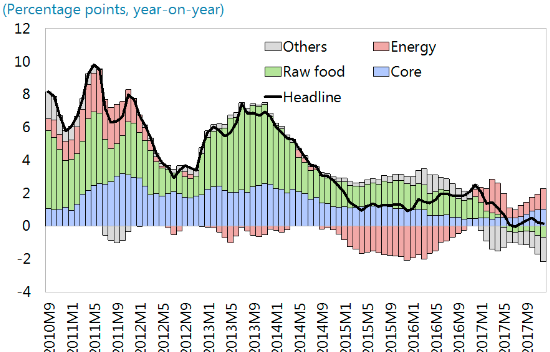
Tourist Arrivals and Revenue
(Percent, year-on-year)



Sources: National authorities; and IMF staff calcualtions.

Headline inflation has inched up on energy prices, but core inflation remains moderate and stable.

Contribution to Headline Inflation
(Percentage points, year-on-year)



Sources: National Authorities; and IMF staff calculations.

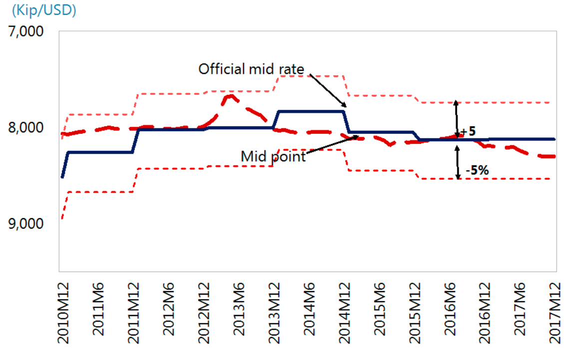
Sources: National Authorities; CEIC; and IMF staff calculations.

Figure 2. Lao P.D.R.: External Sector Vulnerabilities High but Being Ameliorated

The kip exchange rate has depreciated slightly against the US dollar since late-2016...

Exchange Rate

(Kip/USD)

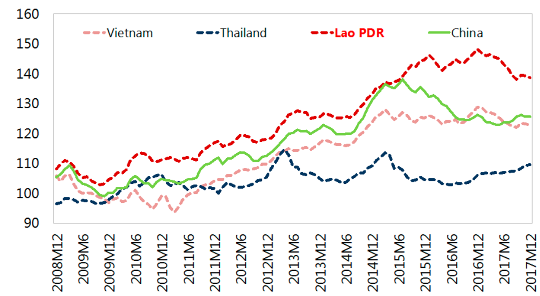


Sources: National authorities; and IMF staff calculations.

...which along with low inflation led to a 6 percent REER adjustment in 2017.

Real Effective Exchange Rate

(Index, 2008=100)

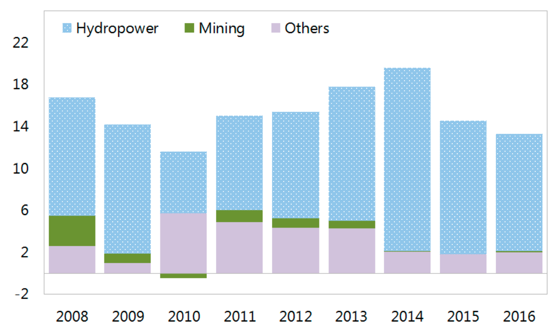


Sources: Bloomberg; IMF, Information Notice System; National authorities; and IMF staff calculations.

FDI continues to be concentrated in hydropower, and has declined as existing energy projects mature.

Net FDI, Private Sector

(Percent of GDP)

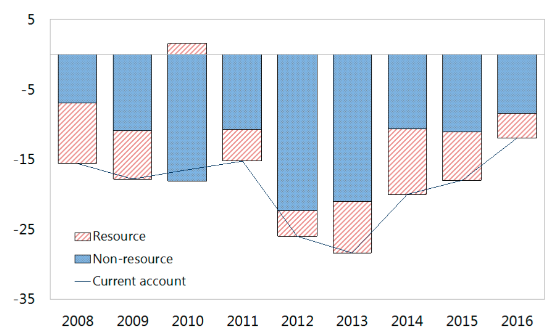


Sources: National authorities; and IMF staff calculations.

The current account deficit has improved as FDI related imports declined.

Current Account Balance

(Percent of GDP)

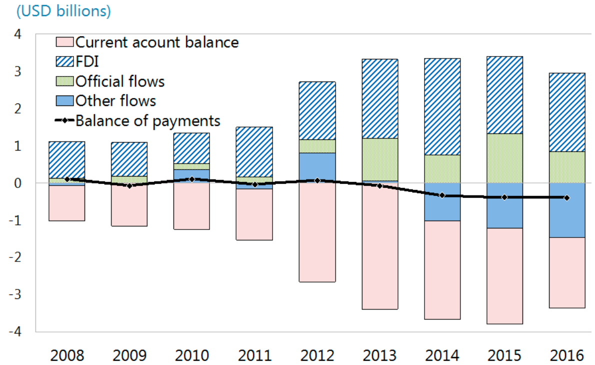


Sources: National authorities; and IMF staff calculations.

FDI and official flows slowed in 2016.

Balance of Payments

(USD billions)

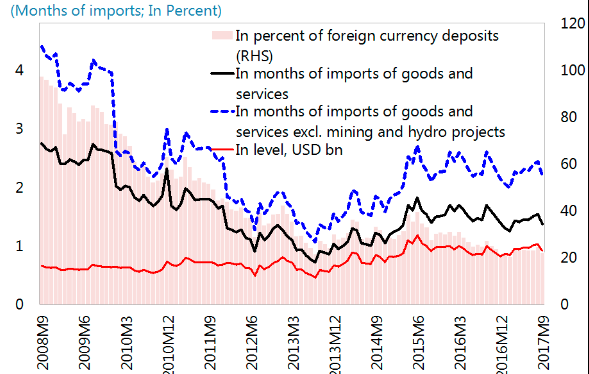


Sources: National authorities; and IMF staff calculations.

International reserves remain well below precautionary needs.

Gross Official Reserves

(Months of imports; In Percent)



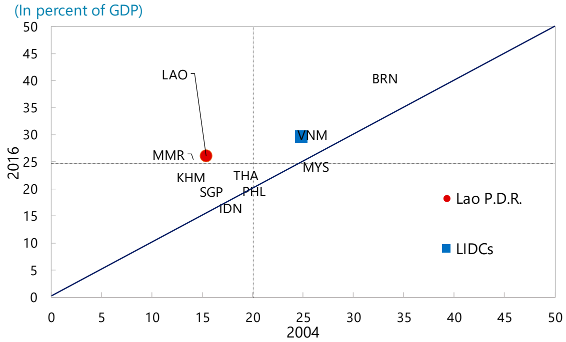
Sources: National authorities; and IMF staff calculations.

Sources: National authorities; IMF FAD Expenditure Assessment Tool (EAT); World Economic Outlook; and IMF staff estimates.

Figure 3. Lao P.D.R.: Fiscal Consolidation Efforts Have Been Reversed

Public spending in Laos has risen quicker than regional peers.

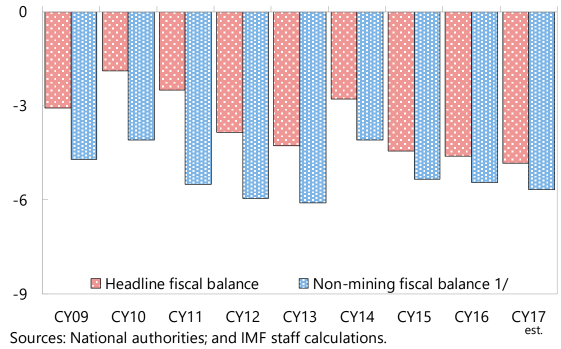
Lao PDR: General Government Spending 1/
(In percent of GDP)



Source: IMF FAD Expenditure Assessment Tool (EAT), World Economic Outlook.
1/ Dashlines are the average of ASEAN.

Following a narrowing in 2014 the fiscal deficit doubled in 2015 and remained high in 2016 and 2017…

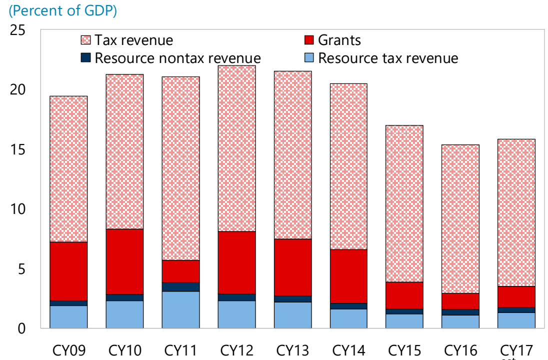
Fiscal Balance
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
1/ Net lending/borrowing minus mining revenues.

…due to a significant fall in tax revenues and grants…

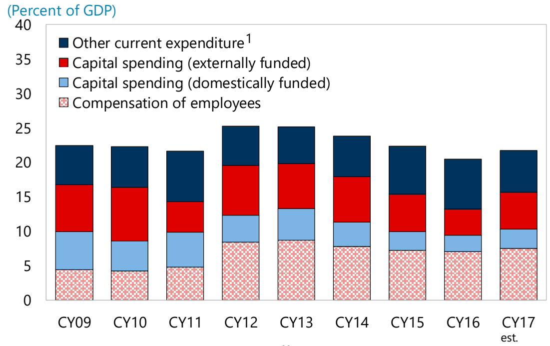
Revenue
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.

…while current spending rose.

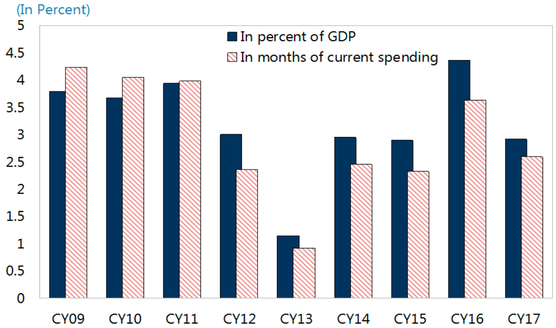
Expenditure
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
[1] Including grant-financed capital expenditure from 2010 onward.

Government deposits rose due to increased foreign borrowing.

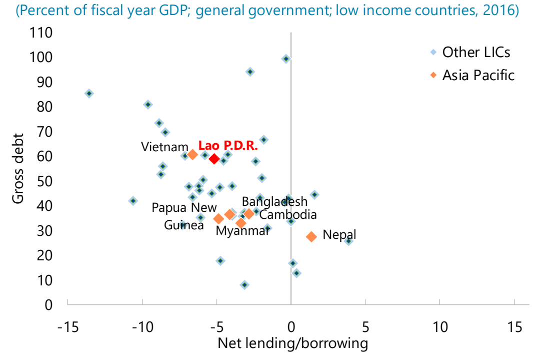
Government Deposits
(In Percent)



Sources: National authorities; and IMF staff calculations.

Consolidation is required to rebuild fiscal space.

Fiscal Space
(Percent of fiscal year GDP; general government; low income countries, 2016)

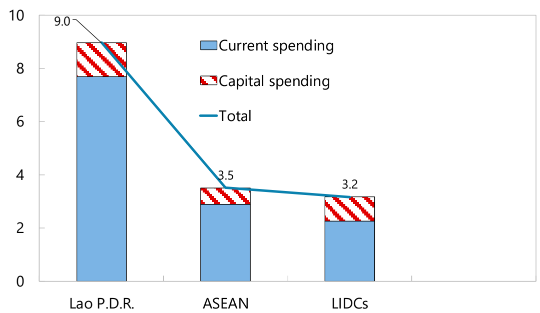


Sources: IMF, WEO; and IMF staff calculations.

Figure 4. Lao P.D.R.: Fiscal Policy Needs Re-Orienting to Become More Pro-Growth

Public spending in Lao has risen faster than regional peers driven by current spending.

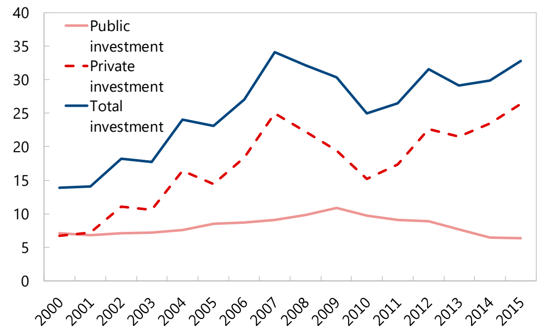
Change in Total Spending, 2004–2016
(In Percent of GDP)



Source: IMF FAD Expenditure Assessment Tool (EAT); World Economic Outlook.

The expenditure mix has become less growth friendly…

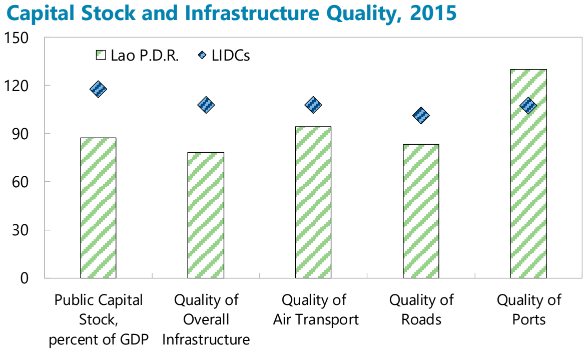
Evolution of Investment
(In Percent of GDP)



Source: IMF FAD Expenditure Assessment Tool (EAT); World Economic Outlook.

…which has hindered infrastructure investment in Lao

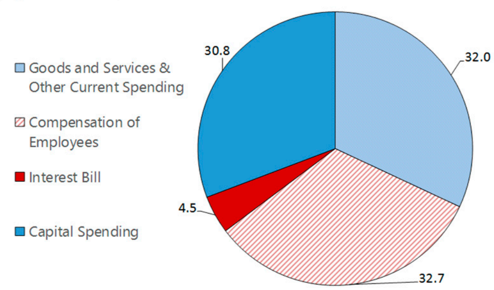
Capital Stock and Infrastructure Quality, 2015



Source: IMF FAD Expenditure Assessment Tool (EAT); World Economic Outlook; World Development Indicators; IMF Investment and Capital Stock Dataset; and World Economic Forum

Public wages are now the biggest component of spending

Economic Classification, 2016
(In percent of total)



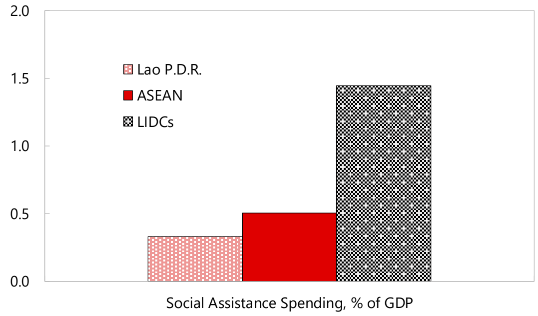
Source: IMF FAD Expenditure Assessment Tool (EAT); World Economic Outlook.

Sources: IMF FAD Expenditure Assessment Tool (EAT); and IMF staff estimates.

Figure 5. Lao P.D.R.: Fiscal Policy Should Be Used to Distribute the Gains of Growth

Social assistance spending remains low...

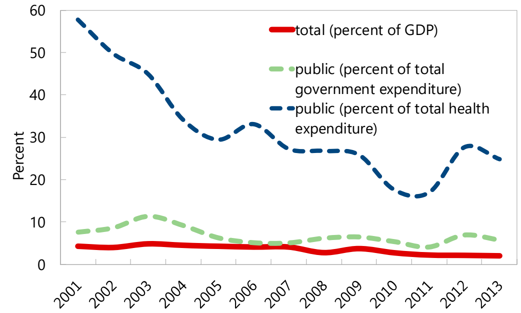
Social Assistance Spending
(In percent of GDP)



Sources: IMF FAD Expenditure Assessment Tool (EAT), World Economic Outlook, ASPIRE, and IMF Pension Indicators.

...reflecting weaker prioritization.

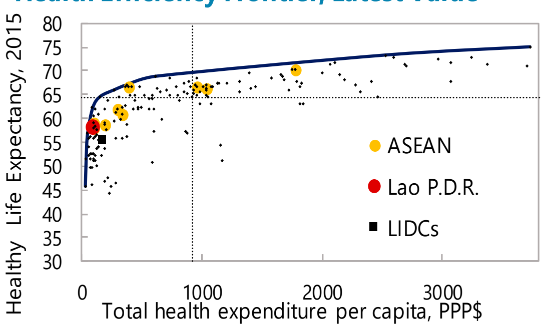
Health Expenditure Trend
(In Percent)



Source: IMF FAD Expenditure Assessment Tool (EAT), World Bank, World Health Organization.

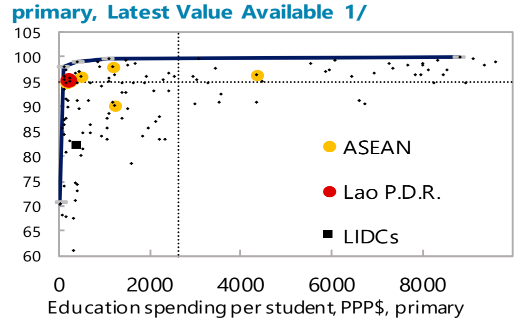
The efficiency of social spending remains in line with peer countries...

Health Efficiency Frontier, Latest Value



Sources: IMF FAD Expenditure Assessment Tool (EAT), World Bank, World Health Organization.

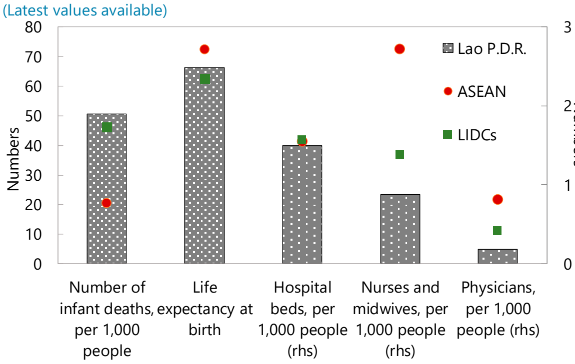
Government Education Spending and Outcome, primary, Latest Value Available 1/



Sources: IMF FAD Expenditure Assessment Tool (EAT), World Bank, World Health Organization.

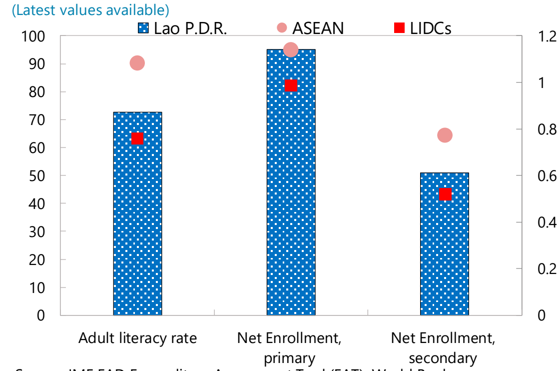
which implies social outcomes, which are currently below the ASEAN average, could be raised by boosting social spending

Helath Indicators and Health System Characteristics
(Latest values available)



Source: IMF FAD Expenditure Assessment Tool (EAT), World Bank, World Health Organization.

Education Indicators
(Latest values available)



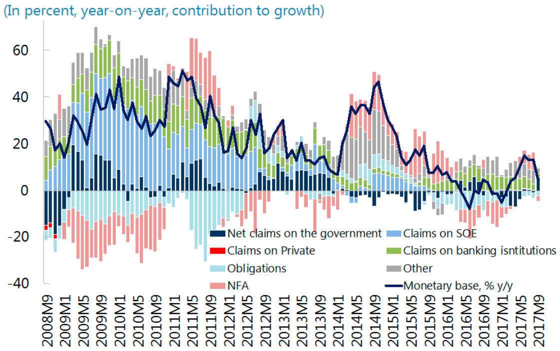
Source: IMF FAD Expenditure Assessment Tool (EAT), World Bank.

Sources: National authorities; IMF FAD Expenditure Assessment Tool (EAT); World Economic Outlook; and IMF staff estimates.

Figure 6. Lao P.D.R.: Financial Conditions Have Loosened

Following a contraction in 2016, reserve money grew in 2017 helping loosen liquidity conditions…

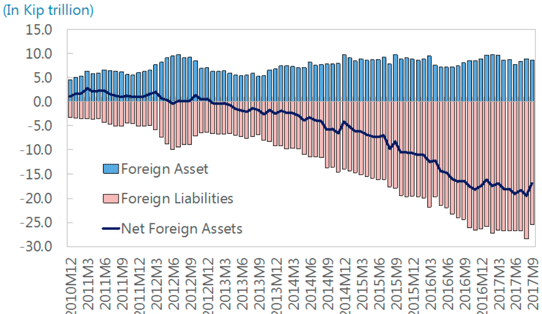
Reserve Money
(In percent, year-on-year, contribution to growth)



Sources: Country authorities; and IMF staff calculations.

…while there was increased external borrowing by banks…

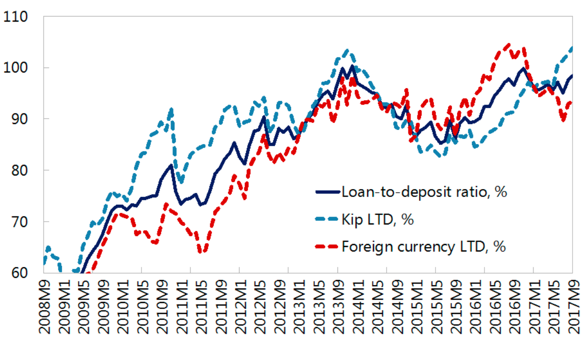
Commerical Banks: Foreign Assets and Liabilities
(In Kip trillion)



Source: Country authorities; and IMF Staff calculations.

…reflecting a shift in banks risk appetite in 2016, following a dip in 2014-15

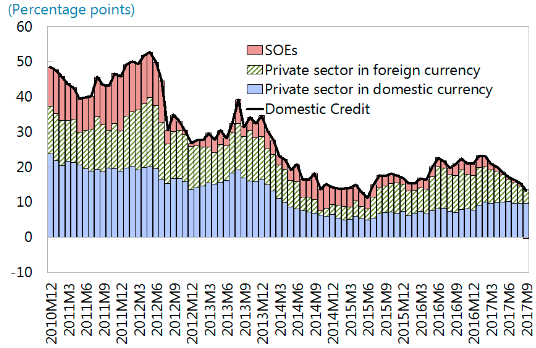
Commercial Banks: Loan-to-Deposit Ratios
(In Percent)



Sources: National authorities; and IMF staff calculations.

As a result, credit grew more quickly in 2016.

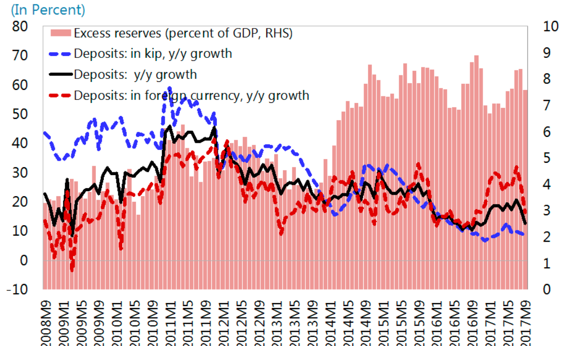
Contribution to Credit Growth
(Percentage points)



Sources: National authorities; and IMF staff calculations.

With stable deposit growth excess (kip) liquidity remains high.

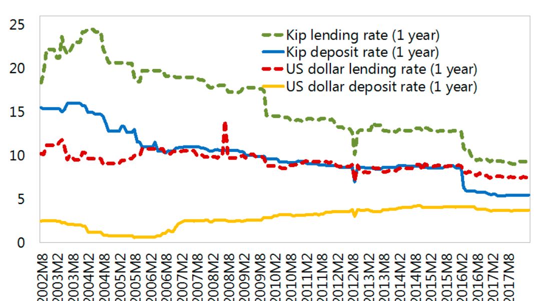
Banks' Excess Reserves and Credit
(In Percent)



Sources: National authorities; and IMF staff calculations.

Caps on deposit and lending rates have lowered interest rates, and impacted bank profitability.

Lending-deposit Rate Spread: Kip and US dollar
(In Percent)

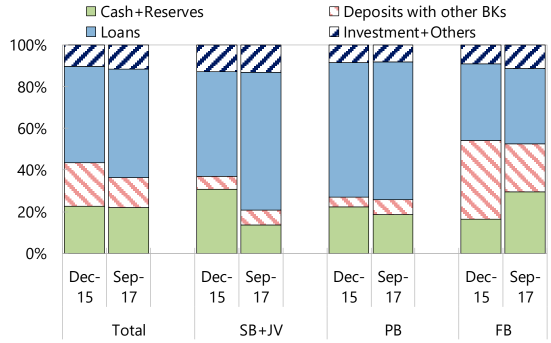


Sources: National authorities; and IMF staff calculations.

Figure 7. Lao P.D.R.: Bank Profitability Remains Weak Due to High NPLs

Recent loan expansion has been driven by public banks selling liquid assets…

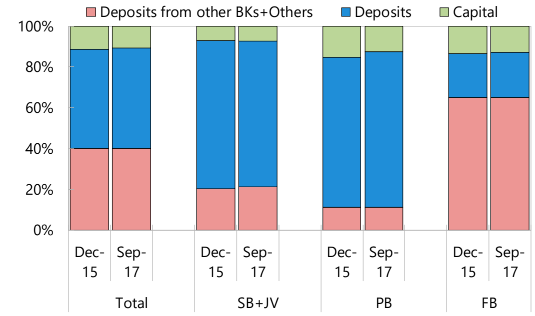
Composition of Assets



Sources: External Audit Reports; and IMF staff calculations.
Note: APB, LDB, and Noyoby are excluded.

…while foreign banks have maintained large borrowings from parent offices.

Composition of Liabilities

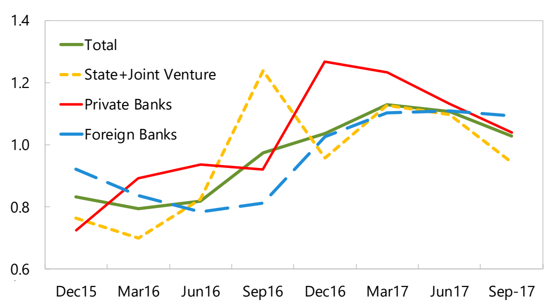


Sources: External Audit Reports; and IMF staff calculations.
Note: APB, LDB, and Noyoboy are exluded.

A higher loan-to-deposit ratio has led to a moderate improvement in bank performance.

Aggregate Average ROA

(In Percent)

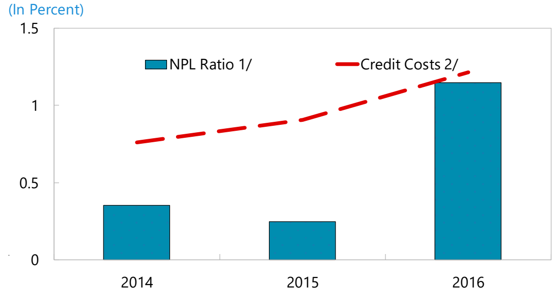


Sources: External Audit Reports; and IMF staff calculations.
Note: APB, LDB, and Noyoby are excluded. ROA is a 4-quarter moving average.

However, given slow NPL recognition, current profitability is not likely to cover credit costs arising from bad loans, suppressing bank profitability.

NPL Ratio and Credit Costs

(In Percent)

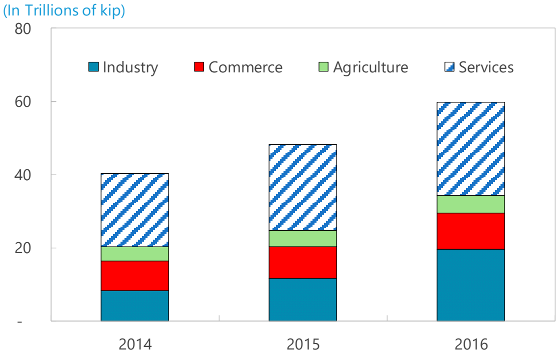


Sources: External Audit Reports; and IMF staff calculations.
1/ APB, BCEL, Lao-Viet Bank, LDB, Noyoboy, and Vietin Bank are excluded.
2/ APB, BCEL, Lao-Viet Bank, Booyoung Bank, LDB, Noyoboy, Vietin Bank, and Cathay are excluded.

Credit expansion continues, concentrated in services and industry…

Credit by Sector

(In Trillions of kip)

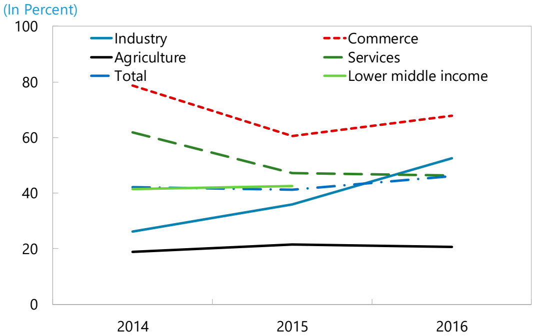


Source: CEIC

…while the credit intensity of output in these sectors has also risen.

Sector Credit-to-Sector GDP Ratio

(In Percent)



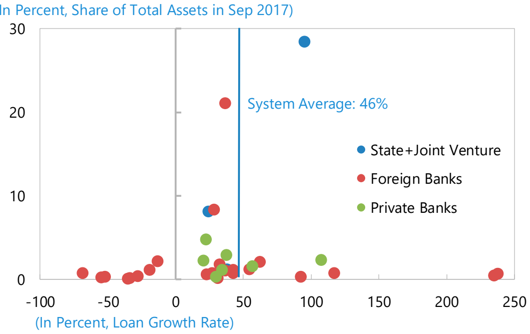
Sources: CEIC; and World Bank.

Figure 8. Lao P.D.R.: Credit Expansion Has Raised Concentration Risks and Squeezed Capital Buffers

A large bank has lead the recent credit expansion.

Loan Growth by Bank: Dec 15 to Sep 17

(In Percent, Share of Total Assets in Sep 2017)

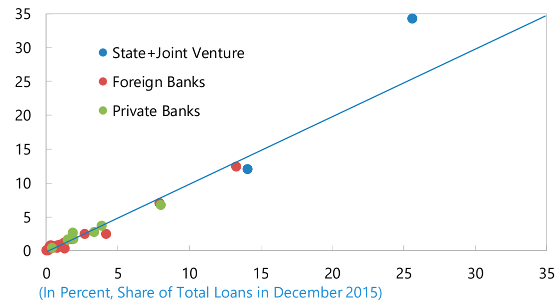


Sources: External Audit Reports; and IMF staff calculations.
Note: APB, LDB, and Noyoby are excluded.

...increasing the degree of concentration in the sector.

Change in Loan Share by Bank: Dec 15 to Sep 17

(In Percent, Share of Total Loans in Sep 2017)

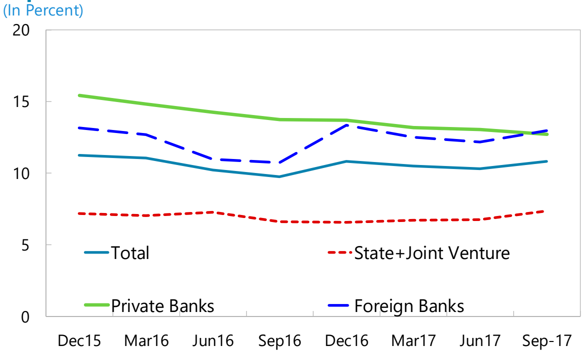


Sources: External Audit Reports; and IMF staff calculations.
Note: APB, LDB, and Noyoby are exluded.

Capital-to-Asset ratios have been flat...

Capital-to-Asset Ratio

(In Percent)

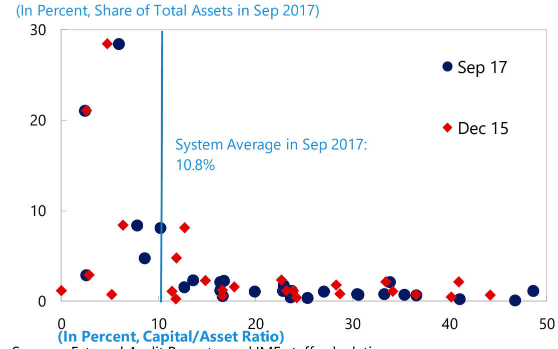


Sources: External Audit Reports; and IMF staff calculations.
Note: APB, LDB, and Noyoby are excluded.

...and the large banks have particularly low capital ratios.

Change in Capital-to-Asset Ratio by Bank

(In Percent, Share of Total Assets in Sep 2017)

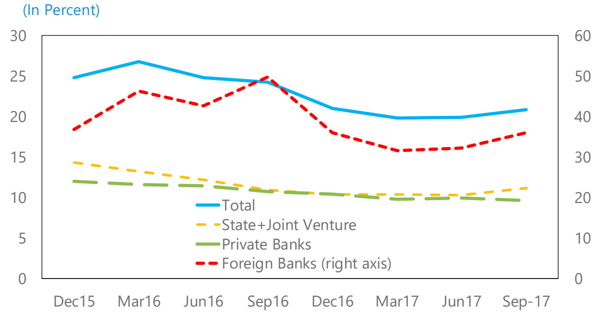


Sources: External Audit Reports; and IMF staff calculations.
Note: APB, LDB, and Noyoby are exluded.

Capital-to-loan ratios have declined since mid-2016.

Capital-to-Loan Ratio

(In Percent)

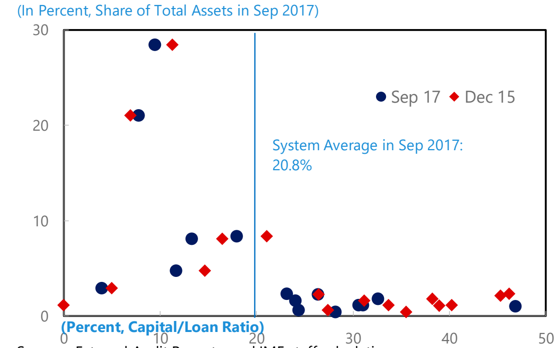


Sources: External Audit Reports; and IMF staff calculations.
Note: APB, LDB, and Noyoby are exluded.

...which has squeezed large banks' capital buffers.

Change in Capital-to-Loan Ratio by Bank

(In Percent, Share of Total Assets in Sep 2017)

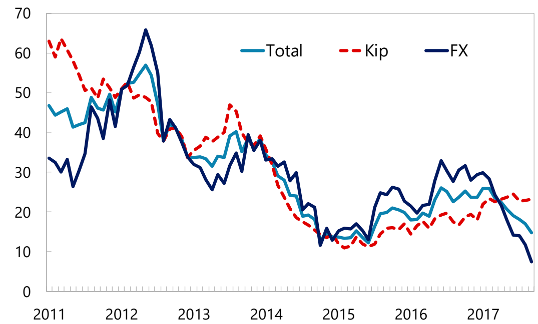


Sources: External Audit Reports; and IMF staff calculations.
Note: APB, LDB, and Noyoby are exluded.

Figure 9. Lao P.D.R.: Increased Foreign Borrowing and Interest Rate Caps Risk Re-Dollarization

FX lending grew faster than local currency lending in 2016 but slowed down in 2017.

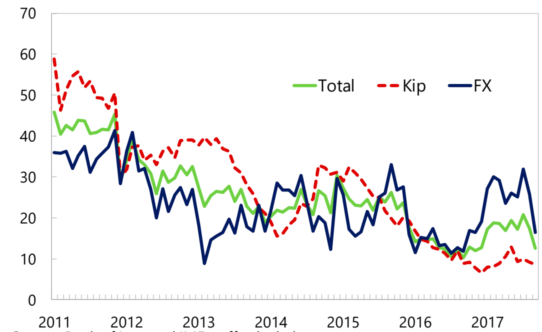
Credit Growth by Currency
(In Percent)



Source: Bank of Lao; and IMF staff calculations.
Note: All commercial banks are included.

FX deposit growth also picked up before moderating in 2017.

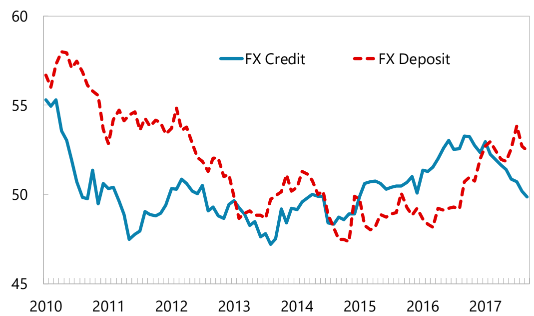
Deposit Growth by Currency
(In Percent)



Source: Bank of Lao; and IMF staff calculations.
Note: All commercial banks are included.

As a result, dollarization remained high.

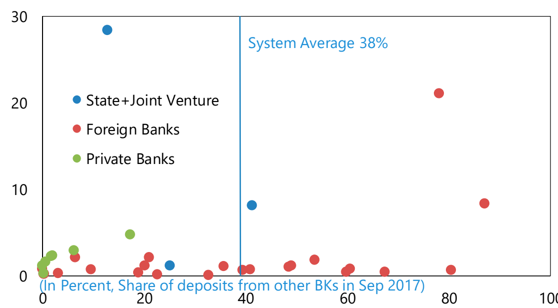
Share of FX Credit and Deposit
(In Percent)



Source: Bank of Lao; and IMF staff calculations.
Note: All commercial banks are included.

Foreign banks' increased reliance on FX borrowings has helped fuel dollar credit.

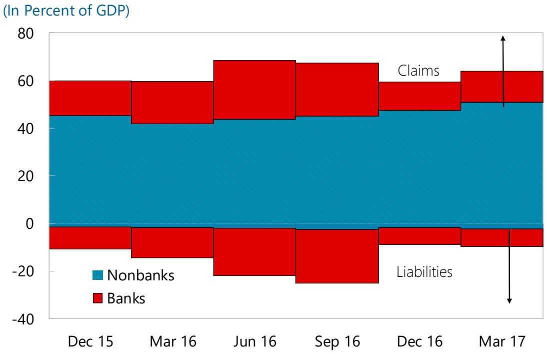
Reliance on Interbank Borrowings by Bank
(In Percent, Share of Total Assets in Sep 2017)



Sources: External Audit Reports; and IMF staff calculations.
Note: APB, LDB, and Noyoby are excluded.

Foreign currency lending has increased risks in the corporate and public sector through currency mismatches.

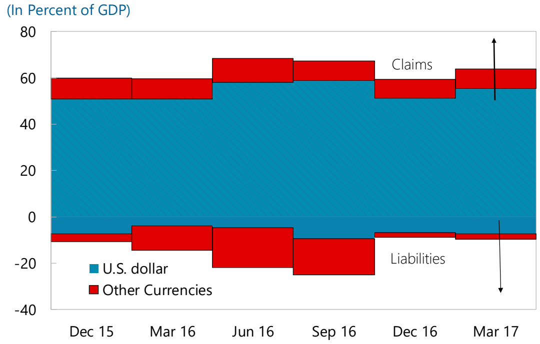
BIS Reporting Banks' Positions in Lao By Couterpart
(In Percent of GDP)



Sources: Bank for International Settlements; and IMF staff calculations.

U.S. monetary policy normalization might add further pressure on dollar lending.

BIS Reporting Banks' Positions in Lao By Currency
(In Percent of GDP)

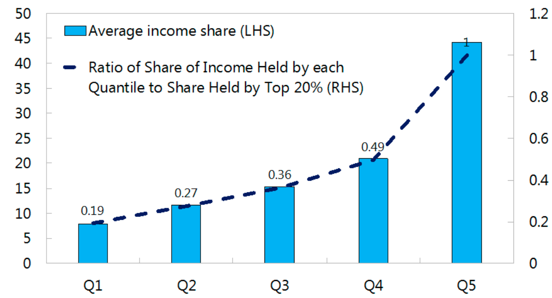


Sources: Bank for International Settlements; and IMF staff calculations.

Figure 10. Lao P.D.R.: Income and Gender Inequality Remain Very High

Income distribution during 1992-2012 was skewed towards the richest 20% of the population ...

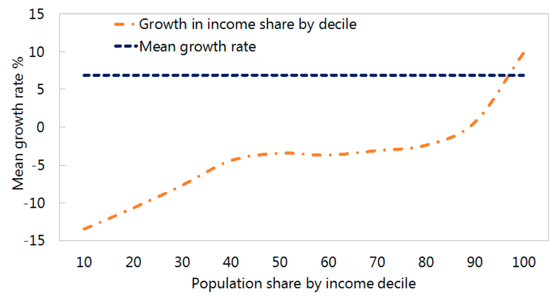
Income Shares, by Income Quantile in the Population



Sources: UNU-WIDER; and IMF staff calculations
Note: Share of total consumption going to each fifth of the population.

... the income share of the richest 10% grew faster than the mean growth rate.

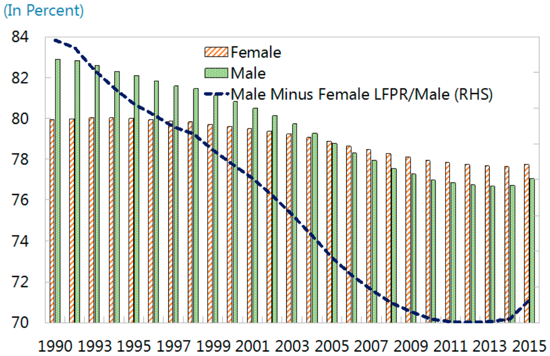
Growth in Income Share, by Income Decile in the Population
(Difference Between Mean Growth Rate and Income Share)



Sources: UNU-WIDER; and IMF staff calculations

Women's representation in the labor force is higher than that of men...

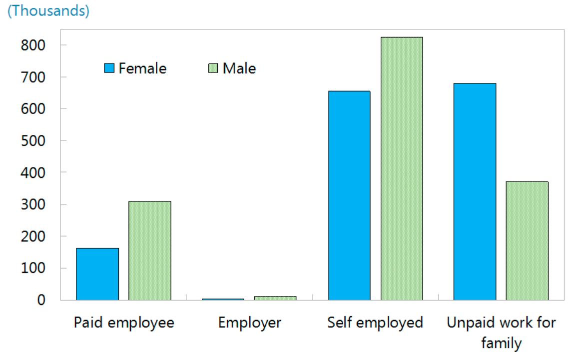
Labor Force Participation Gap
(In Percent)



Source: World Bank, WDI; IMF staff calculations
Note: Male minus female labor force participation rates

.... but considerably less women are paid employees

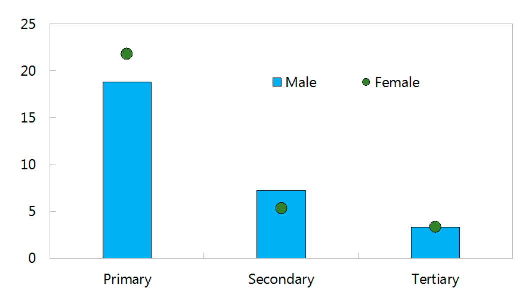
Status of Employment
(Thousands)



Sources: Labor Force Survey, 2010; IMF staff salculations

Female education completion is lagging in secondary education...

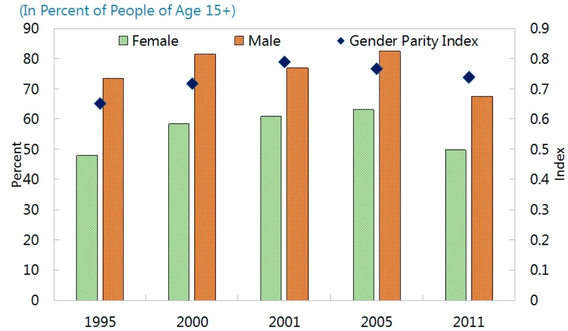
Education Completion Ratio, 2010
(In Percent of Male and Female of Age 15+)



Source: World Bank WDI; IMF staff Calculations

This is reflected in the high gender gap in literacy rates over time.

Adult Literacy Rate
(In Percent of People of Age 15+)



Source: World Bank, WDI; IMF staff calculations
Note: Average of 5 data points (1995-2011)

Table 1. Lao P.D.R.: Selected Economic and Financial Indicators, 2013–18

	2013	2014	2015	2016	2017 Proj.	2018 Proj.
GDP and prices (percentage change)						
Real GDP growth	8.0	7.6	7.3	7.0	6.8	6.8
CPI (annual average)	6.4	4.1	1.3	1.6	0.9	2.3
CPI (end year)	6.6	2.4	0.9	2.5	0.9	2.6
Public finances (in percent of GDP)						
Revenue and Grants	20.9	21.0	17.9	15.8	16.7	17.0
Of which : Mining	2.1	1.8	1.3	0.9	0.9	0.7
Of which : Hydro power	0.8	0.9	0.8	0.8	0.9	0.6
Of which : Grant	4.8	4.5	2.2	1.4	1.8	1.8
Expenditure	25.2	23.8	22.4	20.5	21.5	21.2
Expense	14.0	13.8	14.2	14.5	13.5	13.1
Net acquisition of nonfinancial assets 1/	11.1	10.1	8.1	6.0	8.0	8.1
Overall balance	-4.3	-2.8	-4.5	-4.6	-4.8	-4.3
Nonmining balance 2/	-6.2	-4.6	-5.4	-5.5	-5.7	-5.0
Public and public guaranteed debt (in percent of GDP)	56.3	57.9	57.7	58.5	61.1	65.3
Money and credit (annual percent change)						
Reserve money	7.7	30.3	6.6	-1.4	9.9	9.4
Broad money	18.8	23.4	14.7	10.9	12.9	22.8
Bank credit to the economy 3/	34.5	14.2	16.8	20.9	15.0	18.5
Bank credit to the private sector	36.3	11.7	19.3	22.0	16.5	16.7
Balance of payments						
Exports (in millions of U.S. dollars)	3,501	4,299	3,743	4,379	5,084	5,303
In percent change	5.4	22.8	-12.9	17.0	16.1	4.3
Imports (in millions of U.S. dollars)	7,163	7,817	7,366	6,636	7,538	8,313
In percent change	15.1	9.1	-5.8	-9.9	13.6	10.3
Current account balance (in millions of U.S. dollars)	-3,400	-2,657	-2,586	-1,903	-2,204	-2,728
In percent of GDP	-28.4	-20.0	-18.0	-12.0	-13.0	-14.9
Gross official reserves (in millions of U.S. dollars)	662	816	987	815	979	1,023
In months of prospective goods and services imports	1.0	1.3	1.7	1.2	1.3	1.3
Exchange rate						
Official exchange rate (kip per U.S. dollar; end-of-period)	8,030	8,096	8,119	8,231	8,279	…
Real effective exchange rate (2010=100)	113.9	120.9	131.1	134.5	125.9	…
Nominal GDP						
In billions of kip	93,868	106,797	117,252	129,279	140,019	152,822
In millions of U.S. dollars	11,974	13,266	14,363	15,916	16,984	18,337

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

1/ Includes off-budget investment expenditures.
2/ Net lending/borrowing excluding mining revenue.
3/ 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, 2014–22

	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Est.	Proj.	Proj.	Proj.	Proj.	Proj.
(In millions of U.S. dollars; unless otherwise indicated)									
Current account	-2,657	-2,586	-1,903	-2,204	-2,728	-2,751	-2,786	-2,707	-2,761
Merchandise trade balance	-3,518	-3,624	-2,257	-2,454	-3,010	-2,979	-2,970	-3,023	-3,010
Exports, f.o.b.	4,299	3,743	4,379	5,084	5,303	5,843	6,390	5,888	6,209
Mining and hydropower	1,846	1,883	2,444	2,776	2,879	3,231	3,543	2,806	2,891
Other exports	2,454	1,859	1,935	2,308	2,424	2,612	2,847	3,082	3,319
Imports, c.i.f.	7,817	7,366	6,636	7,538	8,313	8,822	9,359	8,911	9,219
Mining, hydropower, railway	2,788	2,585	2,468	2,959	3,244	3,236	3,219	2,200	1,847
Mining projects	463	435	435	422	406	412	230	77	0
Hydropower and railway projects	2,325	2,150	2,033	2,538	2,837	2,823	2,989	2,123	1,847
Petroleum imports	734	383	331	435	527	533	553	595	657
Other imports	4,296	4,399	3,837	4,144	4,543	5,054	5,587	6,117	6,716
Services (net)	373	450	425	360	383	412	417	430	443
Of which: Tourism	621	684	653	609	651	703	732	769	807
Income (net)	-290	-217	-479	-569	-593	-712	-800	-720	-845
Interest payments	-256	-181	-392	-434	-442	-465	-541	-466	-463
Of which: Public	-180	-117	-159	-185	-211	-234	-253	-268	-281
Mining and hydropower	-58	-52	-215	-233	-210	-201	-181	-162	-145
Mining projects	0	0	0	8	11	0	0	0	0
Hydropower projects	-59	-52	-216	-240	-221	-201	-181	-162	-145
Dividends and profit repatriation	-307	-302	-387	-505	-554	-682	-708	-583	-756
Of which: Mining and hydropower	-241	-233	-314	-443	-463	-527	-618	-489	-656
Of which : Mining projects	-171	-158	-135	-263	-268	-260	-214	0	0
Hydropower projects	-71	-75	-178	-180	-195	-267	-404	-489	-656
Other	273	267	299	370	403	436	450	329	374
Transfers (net)	778	805	409	458	492	528	566	607	651
Private	176	185	194	204	214	225	236	248	260
Official	602	620	214	254	278	303	330	359	390
Capital and financial account	2,324	2,194	1,501	2,369	2,773	2,954	2,936	2,930	2,939
Public sector	738	1,318	840	842	802	746	720	688	700
Disbursements	863	1,475	1,093	1,134	1,145	1,088	1,062	1,030	1,043
Amortization	-125	-157	-252	-292	-342	-342	-342	-342	-342
Banking sector (net)	-18	789	813	171	36	34	157	131	110
Private sector	1,605	87	-153	1,356	1,935	2,174	2,060	2,110	2,128
Foreign direct investment (net) 1/	2,598	2,076	2,110	2,814	2,898	2,754	2,353	2,566	2,713
Of which: Mining and hydropower projects	2,325	1,814	1,789	2,241	2,084	1,691	1,294	1,432	1,553
Of which: Mining projects	10	-5	20	-25	-25	-25	20	0	0
Hydropower projects	2,315	1,820	1,769	2,266	2,110	1,716	1,274	1,432	1,553
Other private flows 3/	-993	-1,989	-2,263	-1,458	-963	-580	-293	-456	-585
Overall balance	-333	-392	-403	165	45	202	150	223	178
Financing	-159	-174	403	-165	-45	-202	-150	-223	-178
Central bank net foreign assets	-159	-174	403	-165	-45	-202	-150	-223	-178
Assets (increase -)	-154	-171	404	-164	-44	-201	-149	-222	-177
Liabilities (reduction -)	-5	-3	-1	-1	-1	-1	-1	-1	-1
Memorandum items:									
Current account balance (in percent of GDP)	-20.0	-18.0	-12.0	-13.0	-14.9	-13.7	-12.7	-11.3	-10.6
Excluding official transfers	-24.6	-22.3	-13.3	-14.5	-16.4	-15.2	-14.2	-12.8	-12.1
Resource current account balance (in percent of GDP) 2/	-9.4	-6.9	-3.5	-5.1	-5.7	-3.7	-2.2	-0.2	0.9
Nonresource current account balance (in percent of GDP)	-10.7	-11.1	-8.5	-7.9	-9.2	-10.1	-10.5	-11.1	-11.5
Imports excluding hydropower and mining related	9.3	-4.9	-12.8	9.9	10.7	10.2	9.9	9.3	9.9
Non-FDI financed CA (in percent of GDP)	-7.6	-8.4	-9.1	-7.6	-5.1	-2.7	-0.6	-1.4	-1.8
Gold production (000s oz.)	169	222	211	210	195	180	180	120	0
Gold price (U.S. dollar per oz.)	1,266	1,160	1,248	1,260	1,308	1,337	1,371	1,401	1,431
Copper production (000s ton)	156	166	166	165	155	160	130	0	0
Copper price (U.S. dollar per ton)	6,863	5,510	4,868	6,179	6,975	7,010	7,013	7,008	7,008
FDI (in percent of GDP)	19.6	14.5	13.3	16.6	15.8	13.7	10.7	10.7	10.4
Gross official reserves	816	987	815	979	1,023	1,224	1,373	1,595	1,772
In months of prospective imports of goods and nonfactor services	1.3	1.7	1.2	1.3	1.3	1.5	1.7	1.9	2.1
(Excluding imports associated with large resource projects)	1.9	2.6	1.9	2.1	2.0	2.2	2.2	2.4	2.6
Nominal GDP at market prices	13,266	14,363	15,916	16,984	18,337	20,059	21,938	23,906	26,022

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.

3/ Includes errors and omissions.

Table 3. Lao P.D.R.: General Government Operations, 2014–2022

	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Est.	Proj.	Proj.	Proj.	Proj.	Proj.
				(In billions of kip)					
Revenue and Grants	23,554	21,968	20,490	23,370	25,905	29,328	32,386	34,978	37,800
Of which: Resource revenue 1/	2,370	1,979	2,051	2,435	2,061	3,391	3,861	3,783	3,435
Nonrenewable resources	1,445	1,100	1,082	1,191	1,093	1,690	1,697	1,082	380
Renewable resources	924	880	969	1,243	968	1,701	2,165	2,702	3,055
Nonresource revenue	16,178	17,285	16,691	18,457	21,092	22,910	25,195	27,532	30,336
Taxes	15,500	16,143	16,068	17,226	18,858	21,550	23,737	25,461	27,250
Of which: Resource revenue 1/	1,841	1,493	1,451	1,810	1,338	2,631	2,908	2,445	1,978
Nonrenewable resources	1,352	1,025	982	1,128	1,025	1,627	1,601	961	358
Renewable resources	488	467	469	681	313	1,004	1,306	1,484	1,621
Nonresource revenue	13,659	14,650	14,617	15,416	17,520	18,919	20,829	23,016	25,271
Income and profit taxes	3,130	3,317	3,375	3,305	4,099	4,871	5,198	5,264	5,418
Income taxes	1,069	1,470	1,624	1,247	1,880	2,183	2,482	2,880	3,344
Profit taxes	2,061	1,847	1,751	2,059	2,219	2,688	2,716	2,384	2,074
Of which: Mining	626	496	508	541	510	1,022	1,029	623	256
Of which: Nonmining	1,435	1,351	1,243	1,518	1,709	1,667	1,687	1,761	1,818
VAT	4,331	4,518	4,302	5,461	5,958	6,652	7,330	8,201	9,069
Excise duties	3,361	3,567	4,042	4,255	4,842	5,207	5,588	6,015	6,428
Import duties	1,396	1,825	1,810	1,376	1,471	1,722	1,994	2,257	2,493
Royalties	1,058	894	843	1,254	728	1,558	1,716	1,646	1,542
Mining	726	529	474	587	515	605	572	338	101
Hydropower	332	365	369	667	213	952	1,144	1,308	1,440
Other taxes	2,223	2,023	1,696	1,574	1,760	1,539	1,911	2,078	2,301
Other revenues	3,048	3,122	2,674	3,666	4,295	4,751	5,320	5,854	6,521
Of which: Dividends	897	747	700	1,077	1,100	1,165	1,394	1,810	1,972
Of which: Resource revenue 1/	529	487	600	625	723	760	954	1,338	1,456
Nonrenewable resources	93	74	100	63	68	63	95	121	23
Renewable resources	436	413	500	562	655	697	858	1,218	1,434
Nonresource revenue	2,519	2,635	2,074	3,041	3,572	3,992	4,366	4,516	5,065
Grants	5,006	2,704	1,748	2,478	2,752	3,027	3,330	3,663	4,029
Expenditure	26,634	27,519	26,455	30,127	32,409	36,167	40,170	44,328	48,790
Expense	15,387	17,533	18,637	18,894	20,057	22,579	25,054	27,665	30,481
Compensation of employees	8,714	8,895	9,194	10,509	10,500	10,973	12,145	13,403	14,709
Transfers	2,513	2,760	2,837	3,280	3,400	3,695	4,101	4,511	5,007
Interest payments	1,064	1,322	1,585	1,661	2,370	2,708	3,060	3,420	3,796
Of which: External	713	1,088	1,238	1,344	1,840	1,921	2,116	2,288	2,437
Other recurrent (including arrears)	3,096	4,557	5,021	3,444	3,787	5,205	5,747	6,331	6,969
Net acquisition of nonfinancial assets	11,248	9,986	7,818	11,233	12,352	13,587	15,116	16,663	18,309
Domestically financed (including arrears)	3,897	3,343	2,947	4,000	4,600	5,160	5,954	6,701	7,478
Externally financed	7,350	6,642	4,871	7,478	7,752	8,427	9,162	9,961	10,832
Net lending/borrowing	-3,080	-5,551	-5,965	-6,757	-6,504	-6,839	-7,783	-9,350	-10,990
Net acquisition of financial assets	260	-1,726	-2,301	0	0	0	0	0	0
Domestic	260	-1,726	-2,301	0	0	0	0	0	0
Foreign	0		0	0	0	0	0	0	0
Net incurrence of liabilities	5,930	6,462	5,965	6,757	6,504	6,839	7,783	9,350	10,990
Domestic	2,671	1,384	-399	4,611	4,376	4,752	5,308	6,603	7,890
Foreign	3,259	4,876	6,364	2,146	2,127	2,087	2,476	2,748	3,100
Discrepancy	2,502	-814	2,301	0	0	0	0	0	0
Memorandum items:									
Net lending including discrepancy	…	…	…	…	…	…	…	…	…
Nonmining balance 2/	-4,526	-6,650	-7,047	-7,948	-7,597	-8,528	-9,480	-10,432	-11,370
Operating balance	8,167	4,435	1,853	4,476	5,848	6,749	7,333	7,312	7,319
Domestic financing	2,411	3,110	1,902	4,611	4,376	4,752	5,308	6,603	7,890
Mining revenue	1,469	1,100	1,082	1,191	1,093	1,690	1,697	1,082	380
Hydropower revenue	924	880	969	1,243	968	1,701	2,165	2,702	3,055
Nonresource revenue	16,178	17,285	16,691	18,457	21,092	22,910	25,195	27,532	30,336
Real expenditure (percent, year-on-year) 3/	0	0	0	0	0	0	0	0	0
GDP	106,797	117,252	129,279	140,019	152,822	168,514	186,086	204,991	225,640

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.

3/ Data was revised to bring on budget grant-financed capital expenditure.

Table 3. Lao P.D.R.: General Government Operations, 2014–2022 (Concluded)

	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Est.	Proj.	Proj.	Proj.	Proj.	Proj.
	(In percent of CY GDP, unless otherwise indicated)								
Revenue and Grants	21.0	17.9	15.8	16.7	17.0	17.4	17.4	17.1	16.8
Of which: Resource revenue 1/	2.1	1.6	1.6	1.7	1.3	2.0	2.1	1.8	1.5
Nonrenewable resources	1.3	0.9	0.8	0.9	0.7	1.0	0.9	0.5	0.2
Renewable resources	0.8	0.7	0.7	0.9	0.6	1.0	1.2	1.3	1.4
Nonresource revenue	14.4	14.0	12.9	13.2	13.8	13.6	13.5	13.4	13.4
Taxes	13.9	13.1	12.4	12.3	12.3	12.8	12.8	12.4	12.1
Of which: Resource revenue 1/	1.7	1.2	1.1	1.3	0.9	1.6	1.6	1.2	0.9
Nonrenewable resources	1.2	0.8	0.8	0.8	0.7	1.0	0.9	0.5	0.2
Renewable resources	0.4	0.4	0.4	0.5	0.2	0.6	0.7	0.7	0.7
Nonresource revenue	12.2	11.9	11.3	11.0	11.5	11.2	11.2	11.2	11.2
Income and profit taxes	2.8	2.7	2.6	2.4	2.7	2.9	2.8	2.6	2.4
Income taxes	1.0	1.2	1.3	0.9	1.2	1.3	1.3	1.4	1.5
Profit taxes	1.8	1.5	1.4	1.5	1.5	1.6	1.5	1.2	0.9
Of which: Mining	0.6	0.4	0.4	0.4	0.3	0.6	0.6	0.3	0.1
Of which: Nonmining	1.3	1.1	1.0	1.1	1.1	1.0	0.9	0.9	0.8
VAT	3.9	3.7	3.3	3.9	3.9	3.9	3.9	4.0	4.0
Excise duties	3.0	2.9	3.1	3.0	3.2	3.1	3.0	2.9	2.8
Import duties	1.3	1.5	1.4	1.0	1.0	1.0	1.1	1.1	1.1
Royalties	1.0	0.7	0.7	0.9	0.5	0.9	0.9	0.8	0.7
Mining	0.7	0.4	0.4	0.4	0.3	0.4	0.3	0.2	0.0
Hydropower	0.3	0.3	0.3	0.5	0.1	0.6	0.6	0.6	0.6
Other taxes	2.0	1.7	1.3	1.1	1.2	0.9	1.0	1.0	1.0
Other revenues	2.7	2.5	2.1	2.6	2.8	2.8	2.9	2.9	2.9
Of which: Dividends	0.8	0.6	0.5	0.8	0.7	0.7	0.7	0.9	0.9
Of which: Resource revenue 1/	0.5	0.4	0.5	0.4	0.5	0.5	0.5	0.7	0.6
Nonrenewable resources	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.1	0.0
Renewable resources	0.4	0.3	0.4	0.4	0.4	0.4	0.5	0.6	0.6
Nonresource revenue	2.2	2.1	1.6	2.2	2.3	2.4	2.3	2.2	2.2
Grants 3/	4.5	2.2	1.4	1.8	1.8	1.8	1.8	1.8	1.8
Expenditure	23.8	22.3	20.5	21.5	21.2	21.5	21.6	21.6	21.6
Expense	13.8	14.2	14.4	13.5	13.1	13.4	13.5	13.5	13.5
Compensation of employees	7.8	7.2	7.1	7.5	6.9	6.5	6.5	6.5	6.5
Transfers	2.2	2.2	2.2	2.3	2.2	2.2	2.2	2.2	2.2
Interest payments	0.9	1.1	1.2	1.2	1.6	1.6	1.6	1.7	1.7
Of which: External	0.6	0.9	1.0	1.0	1.2	1.1	1.1	1.1	1.1
Other recurrent (including arrears)	2.8	3.7	3.9	2.5	2.5	3.1	3.1	3.1	3.1
Net acquisition of nonfinancial assets 3/	10.1	8.1	6.0	8.0	8.1	8.1	8.1	8.1	8.1
Externally financed	6.6	5.4	3.8	5.3	5.1	5.0	4.9	4.9	4.8
Net lending/borrowing	-2.8	-4.5	-4.6	-4.8	-4.3	-4.1	-4.2	-4.6	-4.9
Net acquisition of financial assets	-0.7	-1.4	-1.8	0.0	0.0	0.0	0.0	0.0	0.0
Domestic	-0.7	-1.4	-1.8	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	5.3	5.2	4.6	4.8	4.3	4.1	4.2	4.6	4.9
Domestic	2.4	1.1	-0.3	3.3	2.9	2.8	2.9	3.2	3.5
Foreign	2.9	3.9	4.9	1.5	1.4	1.2	1.3	1.3	1.4
Discrepancy	1.8	-0.6	1.8	0.0	0.0	0.0	0.0	0.0	0.0
Net lending including discrepancy	-4.6	-3.9	-6.4	...	...	...	...	...	...
Nonmining balance 2/	-4.1	-5.3	-5.5	-5.7	-5.0	-5.1	-5.1	-5.1	-5.0
Operating balance	7.3	3.7	1.4	3.2	3.8	4.0	3.9	3.6	3.2
Domestic financing	2.1	2.5	1.5	3.4	2.9	2.9	2.9	3.3	3.6
Mining revenue	1.3	0.9	0.8	0.9	0.7	1.0	0.9	0.5	0.2
Hydropower revenue	0.8	0.7	0.7	0.9	0.6	1.0	1.2	1.3	1.4
Nonresource revenue	14.4	14.0	12.9	13.2	13.8	13.6	13.5	13.4	13.4
Real expenditure (percent, year on year) 3/	2.6	0.9	-5.0	5.7	2.9	8.1	7.4	6.9	6.7
GDP (calender year)	106,797	117,252	129,279	140,019	152,822	168,514	186,086	204,991	225,640

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.
3/ Data was revised to bring on budget grant-financed capital expenditure.

Table 4. Lao P.D.R.: Monetary Survey, 2015–18

	2015	2016	2017				2018
			Q1	Q2	Q3	Q4	
						Proj.	Proj.
	(In billions of kip, unless otherwise indicated)						
Bank of Lao P.D.R. (BoL)							
Net foreign assets	7,444	7,245	8,395	8,509	8,236	8,618	9,004
In millions of U.S. dollars	915	884	1,021	1,030	991	1,051	1,098
Net domestic assets	13,686	13,590	13,581	14,054	14,194	14,285	16,062
Government (net)	4	18	-1,212	-365	350	-983	-983
Claims	1,117	1,117	1,117	1,117	2,047	1,117	1,117
Deposits	-1,113	-1,099	-2,329	-1,482	-1,697	-2,100	-2,100
State-owned enterprises	6,475	6,454	6,459	6,437	6,415	6,454	6,456
Banks	5,266	6,468	6,413	6,676	6,678	6,413	6,676
BoL securities	-2,066	-2,903	-2,912	-3,338	-3,357	-3,100	-3,100
Other items (net)	4,006	3,553	4,832	4,643	4,108	5,500	7,013
Reserve money	21,131	20,835	21,976	22,563	22,430	22,903	25,067
Currency in circulation	8,290	7,837	8,768	8,629	8,638	9,658	10,571
Bank Reserves	12,840	12,998	13,208	13,934	13,792	13,244	14,496
Of which: Foreign currency	5,426	5,493	5,581	5,888	5,828	5,597	6,126
Monetary survey							
Net foreign assets	-2,029	-11,268	-9,712	-11,743	-9,903	-12,800	-14,101
In millions of U.S. dollars	-249	-1,374	-1,181	-1,421	-1,195	-1,561	-1,719
Of which: Commercial banks	-1,165	-2,258	-2,201	-2,451	-2,186	-2,612	-2,817
Net domestic assets	62,028	77,808	79,626	82,976	82,189	87,897	106,357
Government (net)	4,794	4,396	3,873	5,193	3,923	5,179	9,555
Budget	4,207	3,808	3,285	4,605	3,335	4,591	8,967
Claims	7,067	7,889	7,903	7,768	6,970	8,672	13,048
Deposits	-2,860	-4,080	-4,618	-3,163	-3,635	-4,080	-4,080
Other	588	588	588	588	588	588	588
Credit to the economy	54,766	66,199	67,734	69,700	71,570	76,129	90,213
In kip	27,250	29,303	32,597	34,193	35,747	38,669	45,823
In foreign currencies	27,516	34,589	35,137	35,507	35,823	37,460	44,390
Of which: Private credit	43,476	53,028	54,580	57,015	58,813	61,755	72,076
In kip	23,931	28,177	29,175	30,807	32,391	…	…
In foreign currencies	19,545	24,851	25,405	26,208	26,422	…	…
Other items (net)	2,467	7,212	8,020	8,083	6,696	6,589	6,589
Broad money	59,999	66,540	69,914	71,233	72,286	75,098	92,257
Currency in circulation	5,880	5,534	6,143	6,092	6,119	7,359	9,041
Kip deposits	27,486	29,303	30,345	30,903	31,460	34,403	42,263
Foreign currency deposits (FCDs)	26,633	31,702	33,426	34,237	34,708	33,336	40,953
	(Annual percent change, unless otherwise indicated)						
Reserve money	6.6	-1.4	3.9	14.7	4.8	9.9	9.4
Broad money	14.7	10.9	17.3	16.4	12.4	12.9	22.8
Credit to the economy	16.8	20.9	20.9	17.1	13.3	15.0	18.5
Credit to the private sector	19.3	22.0	24.2	20.4	17.3	16.5	16.7
In kip	17.2	17.7	22.6	24.6	23.4	…	…
In foreign currencies	22.0	27.1	26.0	15.8	10.5	…	…
Deposit growth	17.6	12.7	18.7	17.2	12.6	11.0	22.8
Memorandum items:							
Velocity	2.0	1.9	2.0	2.0	1.9	1.9	1.7
Money multiplier	2.8	3.2	3.2	3.2	3.1	3.3	3.7
Loan/deposit (percent)	80.3	97.9	96.1	97.1	98.5	102.9	100.7
In kip (percent)	87.1	96.2	96.2	99.7	103.0	…	…
In foreign currency (percent)	73.4	78.4	76.0	76.5	76.1	…	…
Gross official reserves (in millions of U.S. dollars) 1/	987	815	951	959	921	979	1,023
Exchange rate, end-of-period (kip per U.S. dollar)	8,132	8,200	8,225	8,262	8,286	…	…
Nominal GDP (in billions of kip)	117,252	129,279	140,019	140,019	140,019	140,019	152,822
Dollarization rate (FCDs/broad money; in percent)	44.4	47.6	47.8	48.1	48.0	44.4	44.4
Gross reserve/Reserve Money	38	32	36	35	34	35	33
Required reserves	3,226	3,720	3,903	3,992	4,051	4,038	4,960
Excess reserves (percent of GDP)	7.3	6.8	6.4	6.9	6.8	6.8	6.0

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

1/ Defined as foreign assets of the Bank of the Lao P.D.R.

Table 5. Lao P.D.R.: Medium-Term Macroeconomic Framework, 2013–22

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
					Projections					
Output and prices	(Percent change, unless otherwise indicated)									
Real GDP	8.0	7.6	7.3	7.0	6.8	6.8	7.0	7.0	6.9	6.8
Consumer prices (annual average)	6.4	4.1	1.3	1.6	0.9	2.3	3.1	3.3	3.1	3.1
Consumer prices (end-period)	6.6	2.4	0.9	2.5	0.9	2.6	2.9	3.1	3.1	3.1
GDP per capita (in U.S. dollars)	1,900	2,075	2,212	2,417	2,542	2,706	2,918	3,146	3,380	3,627
Public finances (in percent of GDP)										
Revenue	20.9	21.0	17.9	15.8	16.7	17.0	17.4	17.4	17.1	16.8
Tax and nontax revenue	16.1	16.6	15.6	14.5	14.9	15.2	15.6	15.6	15.3	15.0
Mining	2.1	1.8	1.3	0.9	0.9	0.7	1.0	0.9	0.5	0.2
Hydro power	0.8	0.9	0.8	0.8	0.9	0.6	1.0	1.2	1.3	1.4
Others	13.2	13.9	13.5	12.8	13.2	13.8	13.6	13.5	13.4	13.4
Grant	4.8	4.5	2.2	1.4	1.8	1.8	1.8	1.8	1.8	1.8
Expenditure	25.2	23.8	22.4	20.5	21.5	21.2	21.5	21.6	21.6	21.6
Expense	14.0	13.8	14.2	14.5	13.5	13.1	13.4	13.5	13.5	13.5
Net acquisition of nonfinancial assets 1/	11.1	10.1	8.1	6.0	8.0	8.1	8.1	8.1	8.1	8.1
Overall balance	-4.3	-2.8	-4.5	-4.6	-4.8	-4.3	-4.1	-4.2	-4.6	-4.9
Nonmining balance 2/	-6.2	-4.6	-5.4	-5.5	-5.7	-5.0	-5.1	-5.1	-5.1	-4.9
Balance of payments										
Current account balance	-3,400	-2,657	-2,586	-1,903	-2,204	-2,728	-2,751	-2,786	-2,707	-2,761
In percent of GDP	-28.4	-20.0	-18.0	-12.0	-13.0	-14.9	-13.7	-12.7	-11.3	-10.6
Trade balance	-3,662	-3,518	-3,624	-2,257	-2,454	-3,010	-2,979	-2,970	-3,023	-3,010
Exports	3,501	4,299	3,743	4,379	5,084	5,303	5,843	6,390	5,888	6,209
In percent change	5.4	22.8	-12.9	17.0	16.1	4.3	10.2	9.3	-7.8	5.5
Of which: Resources	2,034	1,846	1,883	2,444	2,776	2,879	3,231	3,543	2,806	2,891
In percent change	0.6	-9.2	2.0	29.8	13.6	3.7	12.2	9.6	-20.8	3.0
Imports	7,163	7,817	7,366	6,636	7,538	8,313	8,822	9,359	8,911	9,219
In percent change	15.1	9.1	-5.8	-9.9	13.6	10.3	6.1	6.1	-4.8	3.5
Of which: Resources	2,561	2,788	2,585	2,468	2,959	3,244	3,236	3,219	2,200	1,847
In percent change	33.8	8.9	-7.3	-4.5	19.9	9.6	-0.3	-0.5	-31.7	-16.1
Services and income (net)	24	83	233	-54	-208	-210	-300	-382	-290	-401
Transfers	238	778	805	409	458	492	528	566	607	651
Capital account balance	3,323	2,324	2,194	1,501	2,369	2,773	2,954	2,936	2,930	2,939
Of which: FDI	2,125	2,598	2,076	2,110	2,814	2,898	2,754	2,353	2,566	2,713
Overall balance	-77	-333	-392	-403	165	45	202	150	223	178
Debt and debt service (excluding unidentified arrears)										
Public and public guaranteed debt (in percent of GDP)	56.2	57.9	57.7	58.5	61.1	65.3	65.9	66.2	67.9	70.1
External debt (in percent of GDP)	90.7	100.1	102.7	104.5	113.7	119.8	122.1	120.5	113.8	107.8
External public and public guaranteed debt (in percent of GDP)	45.8	45.6	45.4	46.6	49.1	49.9	48.8	47.4	46.9	46.5
Gross official reserves										
In millions of U.S. dollars	662	816	987	815	979	1,023	1,224	1,373	1,595	1,772
In months of imports	1.0	1.3	1.7	1.2	1.3	1.3	1.5	1.7	1.9	2.1
In months of imports (excluding resource projects)	1.5	1.9	2.6	1.9	2.1	2.0	2.2	2.2	2.4	2.6
Memorandum items:										
Nominal GDP (in billions of kip)	93,868	106,797	117,252	129,279	140,019	152,822	168,514	186,086	204,991	225,640

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

1/ Includes off-budget investment expenditures.

2/ Net lending/borrowing minus mining revenue.

Appendix I. External Sector Assessment[1,2]

Lao PDR's external position is assessed to be substantially weaker than implied by fundamentals and desirable policies, although several factors are mitigating risks. The vulnerable external position needs strengthening and building-up of buffers. The EBA-lite methodology estimates the real effective exchange rate to be overvalued by 44 to 49 percent at end-2016, and reserves are inadequate for precautionary needs.

1. **High external debt raises vulnerability concerns**. Lao PDR's Net Foreign Asset position is estimated to be mostly composed of FDI liabilities which do not pose a major concern for external sustainability, and public and publicly guaranteed external debt. PPG external debt remains high at around 47 percent of GDP at end-2016, of which more than half is in U.S. dollars. It is estimated to have increased to 49 percent at end-2017. With this high level of foreign-currency denominated debt, and a small cushion of international reserves, the economy remains vulnerable to abrupt exchange rate depreciation.

External Balance Assessment (Lite)

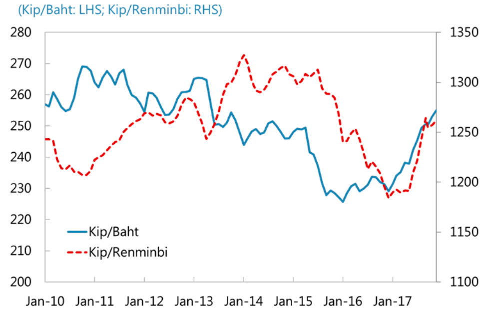
Real Exchange Rate Gap	
Current account approach	43.7%
REER approach	49.4%
Current account	
Actual current account	-11.9%
Current account norm	-1.3%
Current account gap	-10.7%
o/w policy gap	-14.1%
Elasticity of current account	-0.24

Source: IMF staff estimates.

2. **The current account deficit is weaker than implied by fundamentals and desirable policies.** In 2016, Lao PDR's current account deficit was estimated at 12 percent of GDP, a considerable improvement of 6 percentage points over 2015. This can mostly be explained by an increase in electricity exports, as well as a fall in import values on the back of lower commodity prices. Some of this improvement was reversed in 2017, with the current account deficit estimated at 13 percent of GDP. For end-2016, the current account approach under the EBA-lite methodology estimates a cyclically-adjusted current account deficit norm of -1.3 percent of GDP, implying a gap of -10.7 percent. The resulting current account gap translates into a REER overvaluation of 44 percent.

Nominal exchange rate developments

(Kip/Baht: LHS; Kip/Renminbi: RHS)



Sources: Haver; IMF staff calculations

3. **The EBA-lite methodology estimates the real effective exchange rate to be strongly overvalued**. The REER on average appreciated by 4 percent between 2015 and 2016. For end-2016, the IREER model under the EBA-lite methodology estimates an overvaluation of 49 percent compared to the underlying fundamentals and desirable policies. Given that the kip is pegged to the U.S. dollar, which strengthened considerably in 2016, and positive but narrowing inflation differentials with respect to its main trading partners (Thailand and China), the appreciation is mostly related to a nominal appreciation of the kip to the baht and renminbi. This nominal appreciation trend has reversed in 2017.

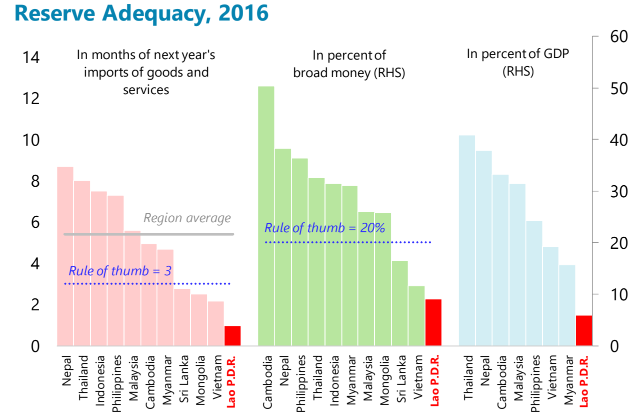
[1] Prepared by Anne Oeking.

[2] This assessment is prepared with the latest annual data available for the EBA-lite methodology, which is for 2016.

4. **Trends in the balance of payments are consistent with an overvaluation of the kip**. A significant proportion of Lao's balance of payments is inelastic to price and exchange rate movements, particularly imports related to FDI projects, electricity exports under fixed price and quantity contracts, and natural resource exports (metals) priced in dollars. Nevertheless, as the overall current account deficit fell by 6 percentage points of GDP from 2015 to 2016, the non-resource current account deficit (which remains high at 8½ percent of GDP in 2016), only fell by three percentage points, mainly reflecting a slowdown in tourism. For 2017, it is estimated that the non-resource current account deficit fell half a percentage point.

5. **Reserves continue to be inadequate for precautionary needs.** Reserve coverage metrics are significantly lower than the level desirable for countries with a fixed exchange rate regime and highly dollarized financial sector, according to the Fund's reserve adequacy metric. As of December 2016, reserves were equivalent to about 1 month of prospective imports of goods and services, 10 percent of broad money, 21 percent of foreign currency deposits and 5 percent of GDP. These reserve coverage levels are significantly below the recommended level of at least three months of prospective imports or up to 20 percent of broad money, respectively, and have further deteriorated compared to 2015. For 2017, reserve coverage levels are expected to remain broadly in line with their 2016 values. The authorities have an alternate accounting which excludes imports related to FDI and improves import cover to around 4 months.

Reserve Adequacy, 2016



Sources: IMF staff calculations

6. **Staff's overall assessment is that the external position is vulnerable to shocks and requires strengthening.** Though several factors, such as the high FDI-cover of imports or recent depreciation of the U.S. dollar mitigate risks, build-up of buffers are needed to address vulnerabilities. Fiscal consolidation and a gradual depreciation of the exchange rate within the current regime would help reverse the trend appreciation and increase international reserves.

Appendix II. Risk Assessment Matrix

Event	Up/Down-side	Probability	Impact	Transmission	Policy Recommendations
Inadequate fiscal consolidation	↓	Medium	High	Public debt rises further, current account deficit deteriorates, loss of confidence, capital outflows, exchange rate pressure, and forced fiscal retrenchment.	Maintain fiscal consolidation efforts; gradually raise non-mining tax revenues; rationalize current expenditures; limit non-concessional external borrowing.
Capital positions for SOCBs deteriorate further due to rising NPLs	↓	High	High	Sharp slowdown in credit growth, tightening in domestic liquidity conditions, capital outflows, putting further pressure on the exchange rate.	Recapitalization of systematically important banks. Eliminate forbearance and ensure that all banks meet the mandatory minimum CAF to reduce possibility of external shocks being amplified by banking system failure. Accelerate NPL resolutions.
Poor agriculture harvest due to slow growth in productivity and extreme weather	↓	Medium	Low	Lower exports to China, Thailand and Vietnam, worsening of current account deficit. Limited contribution to poverty reduction, increase in food price inflation.	Strengthen supply chain connectivity to improve access to markets and improve range of agricultural products, including seeds selection. Promote structural reforms to diversify the economy and improve agricultural productivity.
Tighter global monetary conditions	↓	High	Medium	FX deposit outflow, foreign reserves fall further, exchange rate pressure and the parallel market rate widens.	Build up foreign reserve to buffer against external shocks; allow for greater exchange rate flexibility; where appropriate release limited short-term liquidity to troubled banks; expedite work on a crisis management framework; maintain fiscal consolidation path.
Significant China slowdown and its spillovers	↓	Medium	Medium	Lower commodity prices, a slowdown in tourism and agriculture exports coupled with weaker FDI and banking sector flows.	Expedite structural reforms to accelerate diversification. Improve the business climate and accelerate compliance with WTO commitments. Ensure adequate emergency liquidity.
Lower commodity prices, terms of trade shock	↓	Low	Medium	Lower mineral revenues, fiscal deficit and current account deficit widen, public debt levels rise; tightening in domestic liquidity conditions. Abrupt exchange rate deprecation leads to capital flight and banking system instability.	Maintain a fiscal consolidation path, allow limited exchange rate depreciation and build up international reserves and government deposits. Expedite efforts to raise non-mineral tax revenues.

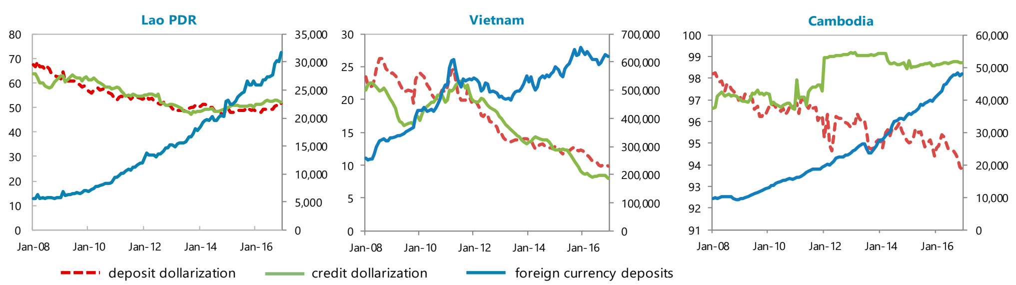
The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term (ST)" and "medium term (MT)" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Appendix III. De-Dollarization in Lao P.D.R.[1]

1. Dollarization, the domestic use of foreign currencies, has been relatively prevalent in Lao PDR, both in currency and assets. Relatively low levels of domestic currency in circulation suggest high levels of *currency substitution*, the use of foreign currency as a means of payment and unit of account. Similarly, *financial dollarization*, which involves banks taking deposits and lending in more than only the local currency, has remained high.

2. Financial dollarization in Lao PDR has been on a declining trend, but has remained at around 50 percent of both deposits and credit over recent years (Figure 1). Compared to other countries in the region, this is a much higher ratio than Vietnam which has managed to successfully de-dollarize to around 10 percent deposit and 8 percent credit dollarization. Financial dollarization in Cambodia, on the other hand, remains high at over 90 percent. Yet in all three countries, foreign currency deposits have been rising. A fall in the deposit dollarization ratio is therefore mostly related to faster growth of local currency deposits and local currency in circulation than that of foreign currency deposits, possibly due to financial deepening.

Figure 1: Dollarization in the Region



LHS: Deposit dollarization in percent of broad money; credit dollarization in percent of total credit to the economy
RHS: foreign currency deposits in (a) billion kip, (b) billion dong, (c) billion riel.

Source: Country authorities; and IMF staff calculations

3. Some de-dollarization is desirable for Lao PDR. While there are benefits to dollarization, such as support of financial development, or facilitation of foreign investment via lower transaction costs and exchange rate risk, adverse effects on macroeconomic policies and financial stability make lower dollarization levels desirable. In Lao PDR, the corporate and banking sectors have been exposed to large risks through currency mismatches, and balance sheet vulnerabilities to foreign exchange risks can make exchange rate flexibility costly. The limited ability of the BOL to provide funding in foreign currency could increase the likelihood of a liquidity crisis.

4. Analytical work on the drivers of financial de-dollarization for Lao PDR and Vietnam shows the importance of macroeconomic stabilization policies and adequate financial policies. Vietnam has successfully de-dollarized on the back of credible macroeconomic policies, prudential measures, a well-functioning foreign exchange market, and domestic financial market development. The empirical results for both countries suggest that well anchored inflation, and exchange rate policy that allows for more volatility and low parallel market premia support de-dollarization; as dollarization is very persistent, further measures such as domestic financial market development and prudential regulation encourage the shift to local currency-denominated products.

[1] Prepared by Anne Oeking.

Appendix IV. 2017–2019 Surveillance Agenda

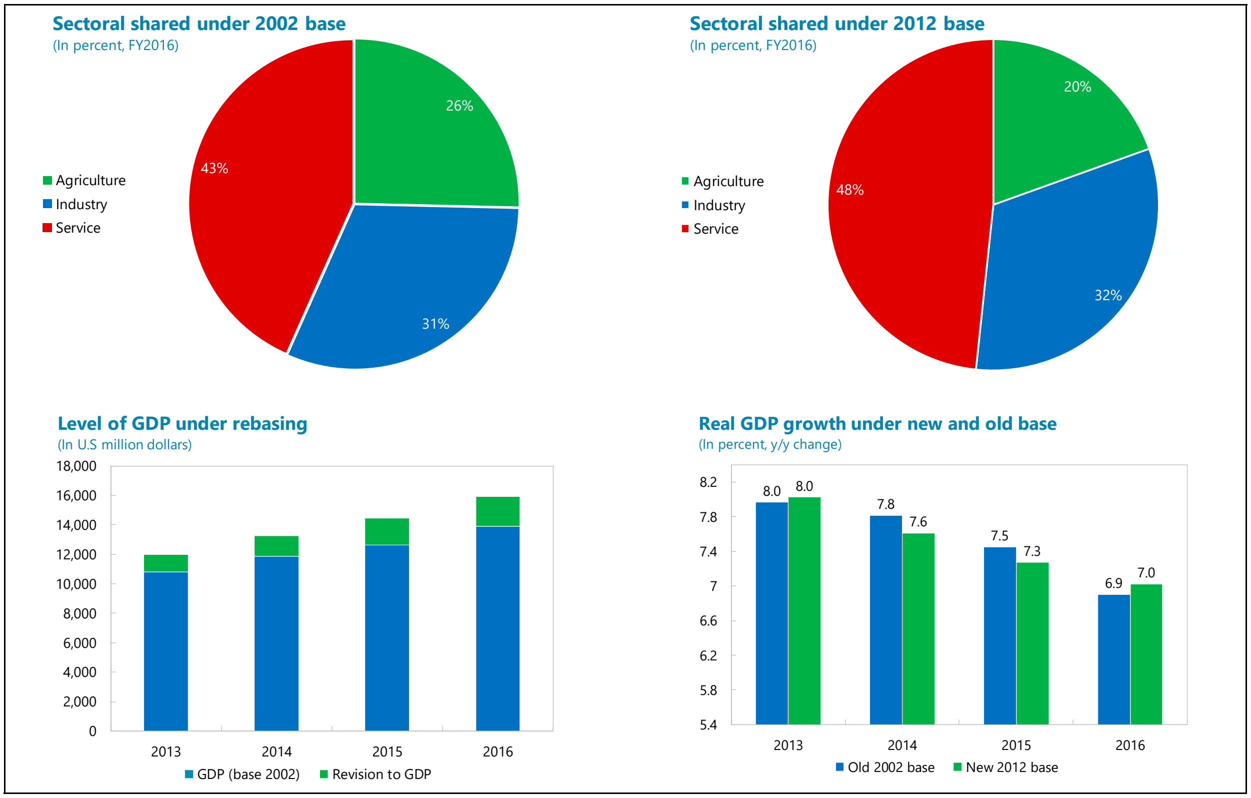
Multi-Year Strategic Surveillance and TA Matrix: Lao PDR

Issues to Cover	Macro-criticality	Traction with authorities	XArticle IV			Integration with TA and capacity building	
			2017	2018	2019	Planned and ongoing	FY2017
1. Traditional macroeconomic Issues (Real, Fiscal, BOP, MON)	H	H	X	X	X	X	X
Issues for Further Integration							
2. Macro-financial Issues							
2-1. Capital Inflows and Spillovers	M	M	F		F		
2-2. Monetary reform and exchange rate liberalization	H	H	F	F	F	X	X
2-3. Banking Sector Soundness	H	H	F	F	F	X	
2-4. Balance Sheet Currency Mismatch	H	H	F				
2-5. Macroprudential Policy	M	M	X	F	F	X	
2-6. Financial Supervision and Regulation	H	H	F	F	F	X	X
2-7. Currency Substitution and De-dollarization	M	M	X	F	F		
3. SDGs/FfD Commitments							
3-1. Domestic Revenue mobilization	H	H	X	F	F	X	X
3-2. Infrastructure Investment	H	H	X	F	F	X	X
3-3. Building Policy space/economic resilience	H	H		X	F		
3-4. Environmental sustainability, equity/inclusion	H	M	X	F	F		
3-5. Fragile and Conflict-Affected States need	N/A	N/A					
3-6. Domestic financial market promotion	H	M		X	F		
3-7. Data enhancement	H	M	F	F	F	X	X
4. Fund's New "Core" Issues							
4-1. Gender	L	L			X		
4-2. Income Inequality	M	M		X			
4-3. Climate Change and Sustainability	H	H		X			

Key: X, new topic; F, follow up on previous year

Appendix V. Rebasing of the National Accounts[1]

1. **The Lao Statistics Bureau (LBS) released rebased GDP numbers for 2012 – 2016, which are based on industry sector weights from 2012, and show nominal GDP to be around 14 percent larger in nominal terms than previously estimated.** By incorporating real estate and education sectors, the rebasing has increased the share of service sector activity in total GDP from 43 to 48 percent. The share of agriculture has declined from 25 to 20 percent. The revised series shows that real GDP growth was 0.2 percent lower in 2014 and 2015 compared to the old GDP based series, but 0.1 higher in 2016.



[1] Prepared by Reach Long.

INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS[1]

February 7, 2018

Approved By
Markus Rodlauer (IMF)
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Prepared by Staff of the International Monetary Fund and International Development Association

Lao P.D.R. faces a high risk of debt distress, based on an assessment of public external debt.[2] The assessment of high risk is reinforced by vulnerabilities related to the existence of currency mismatches and private external debt. Public external debt distress indicators are less elevated than in the 2016 DSA due to the rebasing of GDP, but the debt service-to-revenue ratio breaches its respective threshold in 2019, and remains well above this mark for the full projection period. In addition, several threshold breaches under stress tests reinforce the importance of building buffers for adverse shocks. The present value (PV) of the total public debt-to-GDP ratio also breaches its benchmark. Given the high share of foreign-currency-denominated debt, a large and sudden exchange rate depreciation could raise the level of several indicators significantly, including private external debt, placing debt dynamics on an unsustainable path. Though revenues from large resource projects and U.S. dollar returns of the exporting sectors are expected to mitigate risks over the long term, external borrowing should remain on concessional terms to reduce the debt service burden. There remains an urgent need to recalibrate fiscal policy to rebuild fiscal buffers, adopt clear guidelines for the issuance of sovereign debt and guarantees to help contain debt related risks, and improve debt management, including by developing a comprehensive medium-term debt management strategy and regularly performing a debt sustainability analysis to inform borrowing decisions.

[1] This DSA has been prepared by IMF and World Bank staff, 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 3.29 over the past three years. Since its average CPIA index has been above 3.25, but less than 3.75 for three 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" (http://www.imf.org/external/np/pp/eng/2013/110513.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 2016 Debt Sustainability Analysis (DSA) classified Lao P.D.R.'s risk of debt distress as high,** worsening from the 2014 DSA which assessed risk as moderate, but on the borderline of high risk.

2. **This DSA keeps the risk of debt distress at high.** The indicative debt distress thresholds remain unchanged from the 2016 DSA, since the classification of Lao P.D.R.'s policy performance, according to the Country Policy and Institutional Assessment (CPIA) index, remains moderate. Under the baseline scenario of the current DSA, one of the external and public debt distress indicators, the debt service-to-revenue ratio, breaches the policy-dependent indicative threshold in a substantial and prolonged fashion. All other indicators remain below their respective thresholds under the baseline, an improvement compared to the last DSA, mainly due to a rebasing of GDP in 2017. Overall, the net present value (PV) of external debt follows a downward trend. Under the alternative scenarios, some indicators breach the thresholds for some periods, and the strongest breaches occurred under a one-time depreciation shock.

Lao P.D.R.: External Public Debt Indicators

	Indicative thresholds	End-2016
Present value of debt, as a percent of:		
GDP	40	33.1
Exports	150	100.5
Revenue	250	221.7
Debt service, as a percent of:		
Exports	20	7.0
Revenue	20	15.5

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

Lao P.D.R. Debt-to-GDP Ratio under Rebased GDP

	old GDP	rebased GDP	
	2015	2015	2016
Nominal GDP (in bill. USD)	12.6	14.4	15.9
Public sector debt (in percent of GDP)	65.8	57.7	58.5
PPG external debt (in percent of GDP)	51.7	45.4	46.6

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

3. **Lao P.D.R.'s external public and publicly guaranteed (PPG) debt has risen for the past few years.** The nominal stock of PPG external debt increased from US$6.5 billion at end-2015 to about US$7.4 billion at end-2016, due mainly to higher borrowing from Thailand and China and sovereign bond issuance in the Thai market. The rise in debt was in part driven by heavy investment in power generation projects, part of the strategy to use the country's abundant hydropower resources to export energy to the rapidly growing neighborhood.[3] In addition, the government has continued issuing bonds on the Thai market to support the budget. The PPG external debt ratio increased from 45.4 percent of GDP at end-2015 to 46.6 percent of GDP at end-2016. The corresponding net present value (PV) of PPG external debt stands at 33.1 percent at-end 2016, well below the 40 percent indicative threshold.

Lao P.D.R.: Stock of External PPG Debt at End-2016

	In Billions of U.S. Dollars	As a Share of Total External Debt	In Percent of GDP
Total	7.4	100	46.6
Multilateral	1.6	21.1	9.8
Bilateral	4.7	63.7	29.7
Commercial 1/	1.1	15.1	7.1

Sources: Lao P.D.R. authorities; and IMF and World Bank staff estimates.
1/ Commercial debt includes Thai bond issuance.

[3] The installed capacity in Lao P.D.R.'s power system increased from around 600MW in early 2000 to above 6,000MW most recently with most of the generated electricity is exported to Thailand. The installed capacity is expected to reach above 10,000MW by 2020.

Box 1. Section of the Kunming – Singapore Railway Line

The project involves the construction of a 420-kilometer single track electrified rail line from Vientiane to the northern border with China. Around 60 percent of the railway line will go through tunnels or on bridges. The railway line is a section of the proposed Kunming – Singapore Trans Asian Railway corridor. Construction activities started in 2017 and are expected to be completed in 2021.

The Lao P.D.R. section project cost has been estimated at US$6.7 billion, of which 30 percent will be provided by a joint venture company formed between Lao P.D.R. and China. Lao P.D.R. will contribute 30 percent of the capital of this company (or around US$700 million) in annual installments over the medium term. Of this, US$480 million is borrowed from China while the remaining funds will be provided by the Budget. The Lao P.D.R. Ministry of Finance has noted that no sovereign guarantee will be provided. Per the 2012 Feasibility Study, the IRR is 4.56 percent and the repayment period of investment is 23 years.

4. **Bilateral creditors have been a greater source of loans than multilateral creditors in 2016, and this trend is expected to continue over the projection period.** Bilateral creditors—mainly China, Thailand, Japan, and Korea—accounted for 63.7 percent of total external PPG debt at end-2016. Multilateral creditors consist mainly of the Asian Development Bank (ADB—11.1 percent of total external PPG debt), and the International Development Association (IDA—7.6 percent of total external PPG debt). Sovereign bonds have also been issued in the Thai capital market starting in May 2013. In 2016, bonds equaling around US$334 million were issued, and US$426 million in 2017. The outstanding sovereign bond debt at end-2016 was US$1,114 million, 15.1 percent of total external PPG debt. The issuance of bonds with different maturities indicates the authorities' goal to establish a yield curve. Most recently, the authorities could push the curve to 15 years. A credit rating agency based in Thailand (TRIS Rating Co., Ltd) provided an investment grade rating of BBB+ for the Lao government bonds in the Thai market. This rating is based on strong growth, Lao's abundance of natural resources, rising government revenue from hydropower, and the government's commitment to modernize the economy and alleviate poverty.

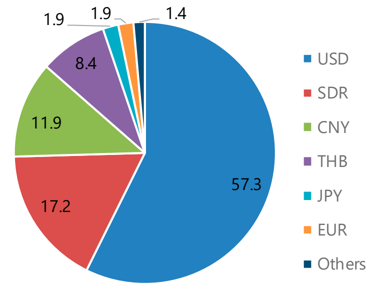
5. **About 57 percent of total external PPG outstanding debt is contracted in U.S. dollars.** The rest consists of SDR (17 percent), yuan (12 percent), baht (8 percent), euro, yen (each 2 percent) and others. The currency composition of the portfolio has changed slightly between end-2015 and end-2016, mostly due to possible issues in the recording of the original currency and eventual shifts in the currency of exposure.

6. **The high, though declining, concessionality of official borrowing helps to reduce the external debt service burden.** The PPG external debt service-to-exports ratio is expected to remain below the policy-dependent indicative threshold throughout the projection period in the baseline scenario. However, the PPG external debt service-to-revenue ratio is expected to exceed the threshold for most of the projection period, due to relatively weak tax revenues. Furthermore, given a high share of U.S. dollars in the currency composition of outstanding external debt and declining concessionality of new borrowing under the current DSA assumptions, these debt service ratios are sensitive to large sudden currency depreciation shocks.

7. Even though the PV of external debt-to-GDP ratio remains below its indicative threshold, the high debt service-to-revenue ratio and vulnerability to stress tests underscore the need to strengthen debt management capacity, including drawing up a comprehensive medium-term debt management strategy. When contracting new debt, debt sustainability considerations should be taken into account, particularly because the country is expected to shift gradually from concessional to more market-based terms. Additional near-term external borrowing, for example to finance large projects, could move the debt burden indicators again closer or over indicative thresholds, potentially undermining debt sustainability. A mitigating factor for Lao P.D.R.'s external debt burden lies in the prospective returns on the hydropower projects that have been financed in part by external PPG debt. The long-term power purchase agreements for these projects and the resulting government revenues in the form of royalties, dividends, and profit tax payments should help to reduce the risk of debt distress in the long run.

Currency Composition of External PPG Debt

(Percent of total)



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

8. Recorded domestic PPG debt fell from 14.1 percent of GDP at end-2015 to about 11.9 percent of GDP at end-2016 on the back of higher GDP due to rebasing. Domestic debt consists of bond/T-bill holdings and the legacy debt of Bank of Lao P.D.R.'s direct lending to local government's off-budget infrastructure projects in the past. The resolution of domestic payment arrears related to public infrastructure projects is underway and is expected to add around 2 percent of GDP to domestic debt in 2018. Given higher costs of domestic borrowing, the share of domestic PPG debt remains relatively small. Going forward, as domestic financial markets deepen, the share of domestic public debt is likely to increase. Total domestic and external PPG debt stood at 58.5 percent of GDP at end-2016, compared to 57.7 percent at end-2015.

ASSUMPTIONS UNDERLYING THE DEBT SUSTAINABILITY ANALYSIS

9. The medium-term macroeconomic assumptions underlying the DSA are summarized in Box 2. The baseline scenario—which is based on current policies and consistent with the macroeconomic framework presented in the staff report—projects annual GDP growth to moderate to 6.8 percent in both 2017 and 2018. Average real GDP growth over the projected period (2017–37) is expected to be 6.4 percent, marginally higher than in the 2016 DSA, reflecting robust energy exports and a more favorable external environment, including higher growth in

Lao P.D.R. Macroeconomic Assumptions
Comparison with previous DSA
(Average over the 20 years projection period)

	2016 DSA	2017 DSA
GDP growth	6.3	6.4
GDP deflator in U.S. dollar terms (percent)	2.1	1.8
Non-interest current account deficit	11.3	7.3
Primary deficit	2.8	2.8

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

China and a rebound in prices of key exports such as commodities and food. GDP deflator growth (in USD terms) is projected to be about 1.8 percent, slightly lower than in the 2016 DSA, in line with lower global inflation. The non-interest current account deficit is projected to fall to 7.3 percent of GDP due to higher electricity exports and rebased GDP. While, on the fiscal side, the primary deficit is expected to remain at its historical average of 2.8 percent of GDP.

Box 2. Baseline Scenario—Underlying Assumptions (2017–37)

Real GDP growth is projected to average 6.9 percent during 2017–22. Growth in 2017 at 6.8 percent reflects robust energy exports and a favorable external environment, including higher growth in China and a rebound in commodity prices. Real GDP is expected to moderate to 6.4 percent on average during 2017–37, as production in the resource sector reaches maturity but, partially, will be offset by strong electricity exports. Graduation from Least Developed Country (LDC) status is projected around the early-2020s.

Inflation (measured by GDP deflator in USD terms) is projected to average about 1.8 percent in 2017–37, slightly lower than in the 2016 DSA, in line with lower global inflation.

The balance of payments continues to be driven by developments in the resource sector, which has an important bearing both on the current account and the capital and financial accounts. The non-interest current account deficit is estimated to have narrowed to about 10.4 percent of GDP in 2017 from 18.1 percent during 2014, but is expected to widen over the medium term, as the railway project is implemented, before it declines to 7.3 percent of GDP on average in the longer term, as the resource balance improves due to the coming on-line of large-scale power projects. FDI inflows are assumed to be robust, driven by growing investment inflows into both resource and non-resource sectors.

External financing is assumed to remain largely on concessional terms in the near term. In the longer-run, however, the degree of concessional financing decreases with economic development, while the new disbursement schedule will shift from multilateral to commercial and bilateral creditors.

- **Multilateral Creditors**: Projected loan disbursements in the medium term are relatively higher than the authorities' projections. New disbursements from IDA are expected to register US$60-70 million a year. Over the longer term, the share of multilateral loans in total disbursements is expected to decline.
- **Bilateral and Commercial Creditors**: Over the medium and longer terms, project loan disbursements are expected to increase, as creditors provide support to the government's development agenda. As Lao P.D.R. exits from low income country status, a larger share of external borrowing is expected to come from bilateral and commercial creditors, with a lower degree of concessionality. This DSA incorporates historical and projected sovereign bond issuance in the Thai market and assumes their continuous roll-over and new bond issuances in the medium term.

Fiscal policy is projected to be neutral in the medium-term. The primary deficit is projected to peak at 3.7 percent of GDP in 2016 and is projected to slightly fall to 2.8 percent over the medium term. Over the long-term the average primary deficit is expected to remain at around 2.8 percent, as modest improvements in non-mining revenue collection come on line, while capital expenditure is expected to ease and other expenditure categories are viewed to remain constant as a percent of GDP.

Domestic debt is expected to increase over the long-term as the country relies more on domestic funding. Going forward, as global interest rates are projected to rise and domestic financial markets deepen, a larger share of financing needs is likely to be satisfied by domestic creditors.

10. **A higher level of financing is assumed than in the 2016 DSA.** To meet the country's financing needs, a higher level of new borrowing is projected to finance investment that would support the country's ambition to graduate from LDC status by 2020. External financing is assumed to remain partially on concessional terms, though with declining grant elements, in the near future, save for sovereign bond issuance on the Thai market. Going forward, however, the new disbursement schedule is assumed to rely less on multilateral creditors, and more on bilateral and commercial creditors. Multilateral assistance will slowly shift from concessional financing to credit-based conditions, and the ADB and the World Bank Group are expected to remain the principal suppliers of multilateral credit, with IDA slowly phasing out and being replaced by IBRD loans with less concessional terms. The level of grant financing is projected to decline over the projection period, adding to the higher projected borrowing needs. As the domestic financial market deepens, the private sector is assumed to rely more on domestic sources of financing, lowering the need for foreign borrowing in the long term.

DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

11. **Under the baseline scenario, the three solvency indicators remain below their respective policy dependent indicative thresholds.** The PV of external debt-to-GDP ratio, PV of external debt-to-exports ratio and the PV of external debt-to-revenue ratio are projected to remain below respective policy dependent indicative thresholds and decline in the medium term (Figure 1). The change from the previous DSA is driven primarily by higher GDP following rebasing.

12. **The current DSA breaches the policy dependent indicative threshold for the debt service-to-revenue ratio.** This breach is prolonged and substantial, providing grounds for the high-risk assessment. The other debt service indicator, the debt service-to-exports ratio, remains well below the policy-dependent indicative threshold during the entire forecast period under the baseline scenario. A mitigating factor for the breach in the debt service to revenue ratio is the expected diversification in the public revenue base in Lao P.D.R. due to returns on the hydropower projects that have been financed in part by the external PPG debt, and the long-term power purchase agreements for these projects in U.S. dollars.

13. **Under the historical scenario, in which key variables are set at their 10-year historic average, debt dynamics become unsustainable for almost all debt indicators.** The historical scenario for Lao P.D.R. builds in more adverse conditions for the current account deficit, real GDP growth, and growth of exports of goods and services than assumed under the baseline scenario, leading to higher debt accumulation rates and placing debt dynamics on an unsustainable path. As shown in Figure 1, under the historical scenario, all debt indicators except the debt service-to-exports ratio are projected to breach the respective policy dependent indicative thresholds.

14. **Moreover, debt dynamics are markedly worse under stress test scenarios, with exchange rate depreciation risk having the largest impact.** An abrupt exchange rate depreciation remains the most important risk to sustainability, given a large share of foreign currency debt and a very thin international reserves cushion. As shown in Figure 1, a one-off 30 percent depreciation shock would cause

the breach of the indicative threshold of the PV of debt-to-GDP ratio, the PV of debt-to-revenue ratio, and debt service-to-revenue ratio over a prolonged period.

B. Public Sector Debt Sustainability Analysis

15. The PV of public sector debt in percent of GDP is projected to breach the benchmark for several years and decline over the long run under the baseline scenario. Current public sector debt dynamics show an improved short-term situation compared to the 2016 DSA, but a worsening of long-run developments. The PV of public sector debt was estimated at 45.0 percent of GDP in 2016 and is expected to increase to around 65 percent before falling to around 54 percent in the long-term under the baseline scenario, below the public debt benchmark of 56 percent. Public sector debt is estimated at 58.5 percent at end-2016, compared to 57.7 percent of GDP at end-2015 in the previous DSA, and is expected to rise to 74.6 percent of GDP by 2026 before declining over the long run.

16. The PV of public sector debt remains sensitive to a large, abrupt exchange rate depreciation and the realization of contingent liabilities. Owing to significant reliance on external borrowing, a sudden 30-percent depreciation of the kip against the U.S. dollar would immediately raise the PV of public sector debt-to-GDP in the medium-term, with unfavorable implications for debt sustainability. Also, given the fragile public banks, recapitalization costs for three banks, which are estimated to be at least about US$250 million (1.8 percent of GDP), could add to the debt burden. Finally, while growing electricity exports are expected to mitigate the risks of public debt sustainability, these will only materialize if markets are secured for the rapidly expanding production at above-cost recovery prices.

17. The above threshold levels and susceptibility to shocks under stress test scenarios highlight risks and the importance of fiscal consolidation over the medium term. As shown in Figure 2 for the fixed primary balance scenario, which assumes an unchanged primary balance from 2017 for the entire projection period, the PV of the debt-to-GDP, debt-to-revenue, and debt service-to-GDP ratios would be higher than the baseline over the projection period.

AUTHORITIES' VIEWS

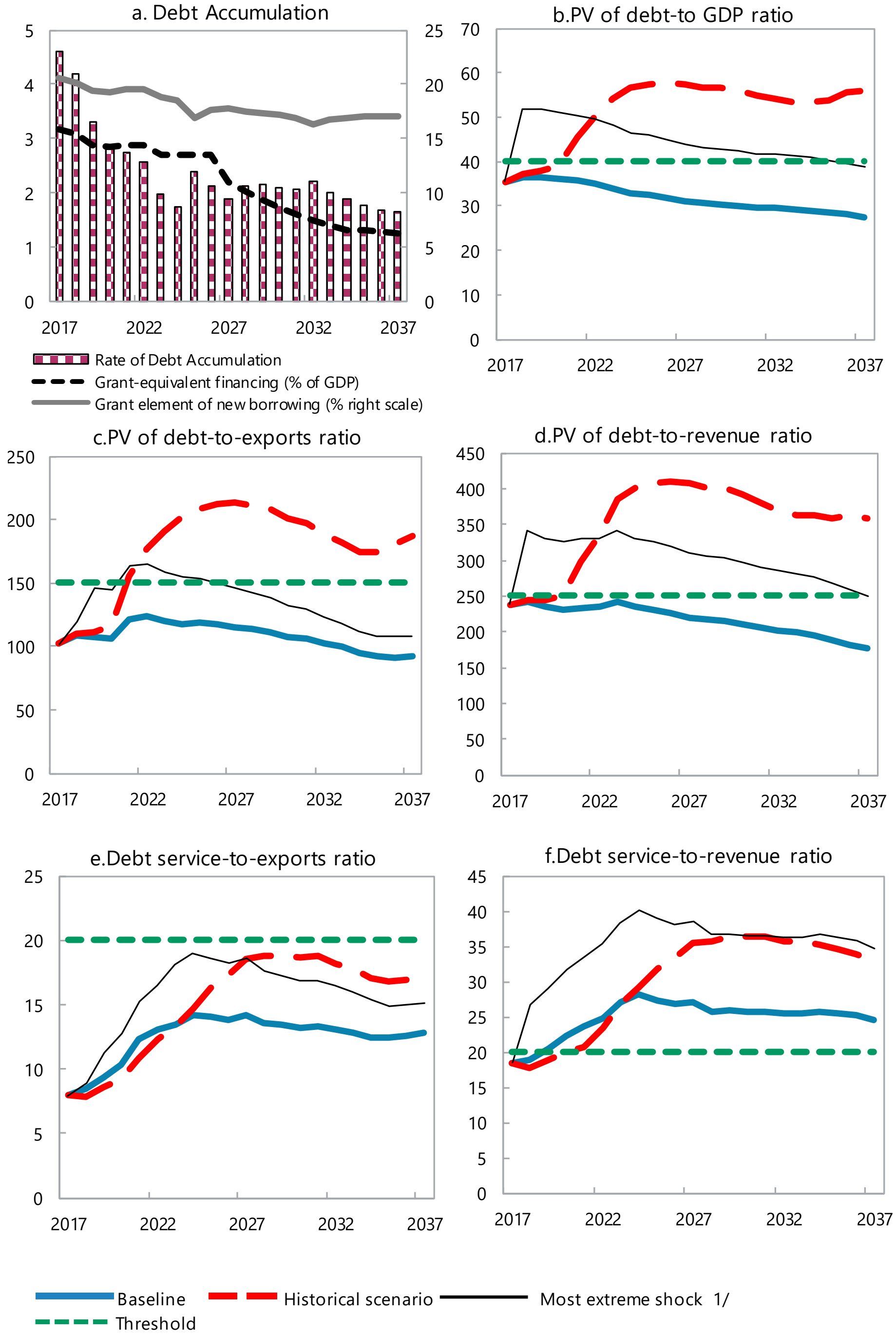
18. The authorities broadly agree with the overall assessment, recognizing the need to take further measures to reduce the debt burden. The government has taken steps to limit its borrowing and limit the contracting of additional debt to concessional borrowing. The government has taken measures to maintain its fiscal deficit and economize budget expenditure, but sees the need for growth supporting spending measures and increased social sector spending; implementing further measures and new legal rules takes time. A new Procurement Law has been implemented, the new Debt Management Law is being prepared, and the Ministry of Finance is in the process of reorganization to merge the management of all debt (domestic and foreign) in one department.

19. The authorities highlight that a significant part of the external debt is related to large, commercially viable hydroelectric projects and do not foresee difficulties in servicing debt. They project that energy projects will generate high and stable economic returns upon completion and will supply enough foreign exchange to service debt. A relatively long maturity profile of loans, as well as U.S. dollar returns of the exporting sectors, would help mitigate the risks of debt distress.

CONCLUSION

20. Lao P.D.R.'s risk of external debt distress remains high, suggesting the urgent need to tighten fiscal policy, strengthen public financial management, and develop a comprehensive medium-term debt management strategy. The PV of the debt service-to-revenue ratio breaches the respective policy-dependent indicative thresholds in the external DSA, and the PV of debt-to-GDP ratio exceeds its benchmark in the public DSA. Both external and public debt indicators are susceptible to shocks, particularly a sudden depreciation of the kip/U.S. dollar exchange rate. Currency mismatches on bank balance sheet and the high level of private external debt reinforce these vulnerabilities. The higher debt stock at end-2016 undermines fiscal space for countercyclical needs and potential banking sector or other contingent costs. Given the considerable share of foreign currency denominated debt, a large sudden exchange rate depreciation could significantly raise the level of those indicators, putting debt dynamics on an unsustainable path. To reduce the debt burden, external borrowing should be contracted on concessional terms as much as possible. The authorities should recalibrate fiscal policy to rebuild fiscal buffers through stronger revenue mobilization efforts and expenditure rationalization, adopt clear guidelines for the issuance of sovereign debt and guarantees, and accelerate the strengthening of the debt management functions including developing a comprehensive medium-term debt management strategy and a regular debt sustainability analysis to inform borrowing decisions.

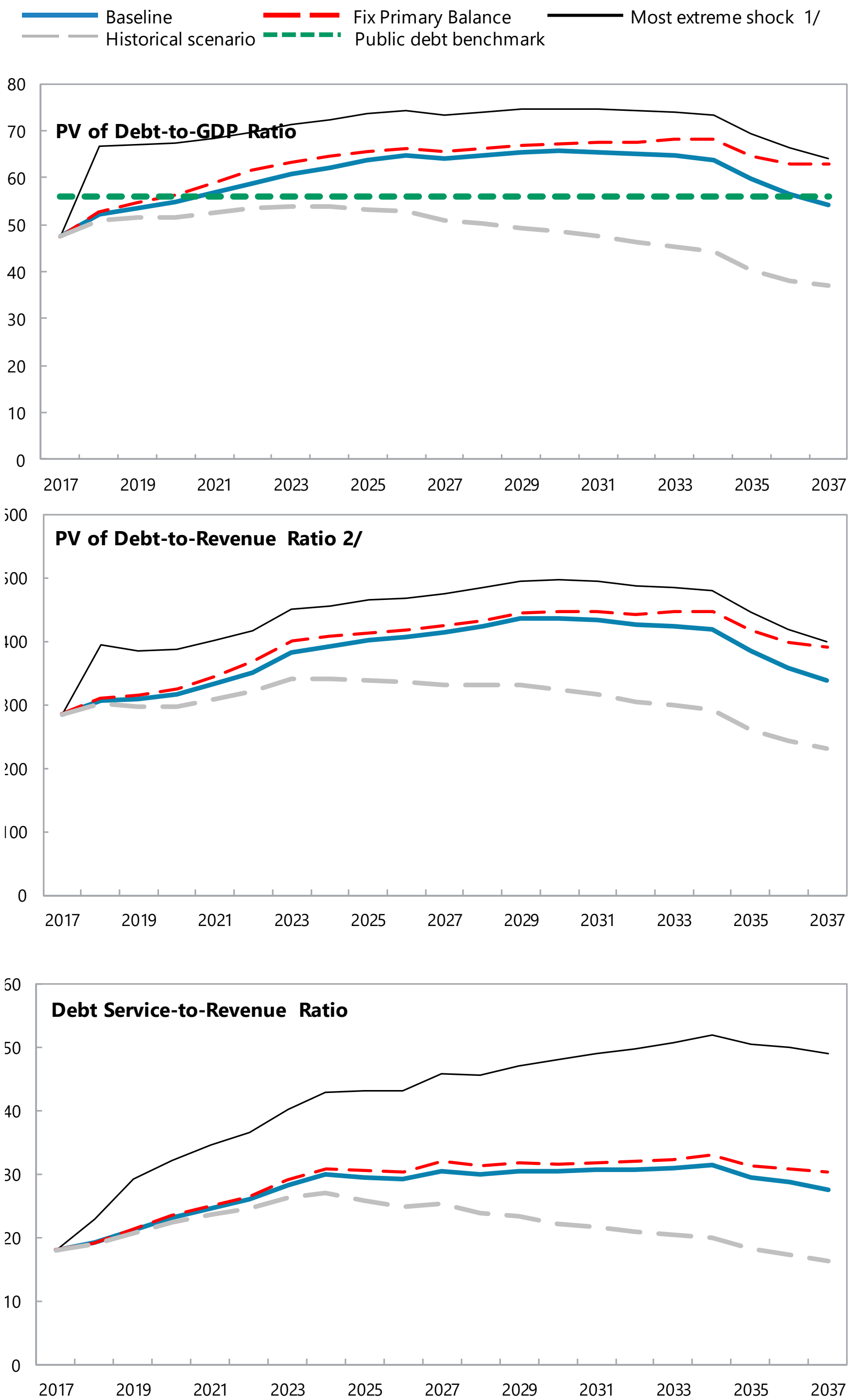
Figure 1. Lao P.D.R.: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2017–37 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2027. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

Figure 2. Lao P.D.R.: Indicators of Public Debt Under Alternative Scenarios, 2017–37 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio on or before 2027.
2/ Revenues are defined inclusive of grants.

Table 1. Lao P.D.R.: External Debt Sustainability Framework, Baseline Scenario, 2014–37 1/

(Percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Projections									
	2014	2015	2016			2017	2018	2019	2020	2021	2022	2017-2022 Average	2027	2037	2023-2037 Average
External debt (nominal) 1/	**100.1**	**102.7**	**104.5**			**113.7**	**119.8**	**122.1**	**120.5**	**113.8**	**107.8**		**82.8**	**57.2**	
of which: public and publicly guaranteed (PPG)	45.6	45.4	46.6			49.1	49.9	48.8	47.4	46.9	46.5		40.7	35.1	
Change in external debt	9.4	2.6	1.8			9.2	6.1	2.3	-1.6	-6.7	-6.0		-3.9	-1.9	
Identified net debt-creating flows	4.0	0.8	-5.1			0.0	1.9	1.0	-0.1	-6.7	-5.0		-1.1	-1.3	
Non-interest current account deficit	**18.1**	**16.7**	**9.6**	**16.5**	**5.7**	**10.4**	**12.5**	**11.8**	**11.0**	**9.1**	**8.3**		**6.8**	**4.1**	6.0
Deficit in balance of goods and services	23.7	22.1	11.5			12.3	14.3	12.8	11.6	10.8	9.9		7.9	5.6	
Exports	38.3	32.1	32.9			34.8	33.8	34.0	33.9	29.3	28.4		26.9	30.0	
Imports	62.0	54.2	44.4			47.2	48.2	46.8	45.5	40.1	38.3		34.8	35.6	
Net current transfers (negative = inflow)	-5.9	-5.6	-2.6	-3.0	1.5	-2.7	-2.7	-2.6	-2.6	-2.5	-2.5		-2.1	-1.2	-1.7
of which: official	-4.5	-4.3	-1.3			-1.5	-1.5	-1.5	-1.5	-1.5	-1.5		-1.3	-0.4	
Other current account flows (negative = net inflow)	0.3	0.2	0.7			0.7	0.9	1.6	1.9	0.8	1.0		1.1	-0.3	
Net FDI (negative = inflow)	**-7.2**	**-9.5**	**-7.0**	**-7.4**	**2.3**	**-6.2**	**-5.8**	**-5.0**	**-5.0**	**-10.3**	**-8.5**		**-4.6**	**-3.2**	-4.3
Endogenous debt dynamics 2/	**-6.9**	**-6.4**	**-7.7**			**-4.1**	**-4.8**	**-5.8**	**-6.1**	**-5.5**	**-4.9**		**-3.4**	**-2.2**	
Contribution from nominal interest rate	1.9	1.3	2.3			2.6	2.3	1.9	1.7	2.2	2.3		1.9	1.0	
Contribution from real GDP growth	-6.2	-6.7	-6.5			-6.7	-7.2	-7.7	-7.8	-7.6	-7.1		-5.3	-3.1	
Contribution from price and exchange rate changes	-2.6	-0.9	-3.5			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**5.3**	**1.8**	**6.9**			**9.1**	**4.2**	**1.3**	**-1.4**	**0.0**	**-1.0**		**-2.8**	**-0.7**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	...	
PV of external debt 4/	...	...	91.0			100.1	106.5	109.7	109.1	102.5	96.4		73.2	49.6	
In percent of exports	...	...	276.7			287.3	314.9	322.6	322.0	350.2	339.4		272.0	165.7	
PV of PPG external debt	**...**	**...**	**33.1**			**35.5**	**36.6**	**36.5**	**36.0**	**35.6**	**35.1**		**31.0**	**27.5**	
In percent of exports	**...**	**...**	**100.5**			**101.8**	**108.2**	**107.4**	**106.3**	**121.6**	**123.4**		**115.3**	**91.9**	
In percent of government revenues	**...**	**...**	**221.7**			**237.6**	**241.7**	**234.0**	**230.6**	**233.0**	**234.3**		**219.5**	**176.0**	
Debt service-to-exports ratio (in percent)	**13.8**	**13.7**	**21.8**			**22.9**	**23.3**	**24.3**	**24.6**	**28.9**	**29.0**		**32.0**	**15.4**	
PPG debt service-to-exports ratio (in percent)	**6.0**	**5.6**	**7.0**			**7.9**	**8.4**	**9.4**	**10.3**	**12.3**	**13.1**		**14.2**	**12.7**	
PPG debt service-to-revenue ratio (in percent)	**14.2**	**11.0**	**15.5**			**18.5**	**18.8**	**20.4**	**22.3**	**23.6**	**24.8**		**27.0**	**24.3**	
Total gross financing need (Billions of U.S. dollars)	2.1	1.7	1.6			2.1	2.7	3.0	3.1	1.7	2.1		4.3	4.7	
Non-interest current account deficit that stabilizes debt ratio	8.7	14.1	7.8			1.2	6.4	9.6	12.5	15.8	14.3		10.7	6.1	
Key macroeconomic assumptions															
Real GDP growth (in percent)	7.6	7.3	7.0	7.7	0.3	6.8	6.8	7.0	7.0	6.9	6.8	6.9	6.6	5.7	6.2
GDP deflator in US dollar terms (change in percent)	3.0	0.9	3.5	7.0	5.1	-0.1	1.1	2.2	2.2	1.9	1.9	1.5	1.9	1.9	1.9
Effective interest rate (percent) 5/	2.4	1.4	2.5	1.9	0.4	2.7	2.2	1.7	1.6	2.0	2.2	2.1	2.3	1.8	2.1
Growth of exports of G&S (US dollar terms, in percent)	18.9	-9.4	13.6	14.9	15.8	13.0	4.8	10.0	8.9	-5.8	5.7	6.1	7.2	5.2	8.6
Growth of imports of G&S (US dollar terms, in percent)	6.9	-5.5	-9.2	16.4	16.6	13.4	10.2	6.3	6.3	-3.9	3.9	6.0	8.1	8.6	7.7
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	20.6	20.1	19.3	19.2	19.6	19.6	19.7	17.8	17.1	17.3
Government revenues (excluding grants, in percent of GDP)	16.2	16.3	14.9			14.9	15.2	15.6	15.6	15.3	15.0		14.1	15.6	14.5
Aid flows (in Billions of US dollars) 7/	0.6	0.5	0.2			0.5	0.5	0.5	0.6	0.6	0.7		0.8	0.7	
of which: Grants	0.6	0.5	0.2			0.3	0.3	0.4	0.4	0.4	0.5		0.5	0.4	
of which: Concessional loans	0.0	0.0	0.0			0.2	0.2	0.2	0.2	0.2	0.2		0.3	0.3	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			3.2	3.1	2.9	2.8	2.9	2.9		2.2	1.3	1.9
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			36.9	37.6	38.9	39.2	39.1	39.3		34.9	23.8	30.5
Memorandum items:															
Nominal GDP (Billions of US dollars)	13.3	14.4	15.9			17.0	18.3	20.1	21.9	23.9	26.0		39.5	85.1	
Nominal dollar GDP growth	10.8	8.3	10.8			6.7	8.0	9.4	9.4	9.0	8.9	8.5	8.6	7.7	8.2
PV of PPG external debt (in Billions of US dollars)			5.2			6.0	6.7	7.3	7.9	8.5	9.1		12.2	23.3	
(PVt-PVt-1)/GDPt-1 (in percent)						4.6	4.2	3.3	2.8	2.8	2.6	3.4	1.9	1.7	2.0
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)	...	...	33.1			35.5	36.6	36.5	36.0	35.6	35.1		31.0	27.5	
PV of PPG external debt (in percent of exports + remittances)	...	...	100.5			101.8	108.2	107.4	106.3	121.6	123.4		115.3	91.9	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	7.0			7.9	8.4	9.4	10.3	12.3	13.1		14.2	12.7	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ 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.

3/ 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.

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

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

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

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, 2014–37

(Percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2014	2015	2016	Average 5/	Standard Deviation 5/	2017	2018	2019	2020	2021	2022	2017-22 Average	2027	2037	2023-37 Average
Public sector debt 1/	57.9	57.7	58.5			61.1	65.3	65.9	66.2	67.9	70.1		73.6	61.7	
of which: foreign-currency denominated	45.6	45.4	46.6			49.1	49.9	48.8	47.4	46.9	46.5		40.7	35.1	
									0.0	0.0	0.0		0.0	0.0	
Change in public sector debt	1.7	-0.2	0.8			2.6	4.3	0.6	0.2	1.8	2.2		-1.0	-2.5	
Identified debt-creating flows	-2.9	-1.9	-0.6			1.2	-0.5	-1.7	-1.6	-1.1	-0.9		-0.9	-2.8	
Primary deficit	1.5	1.6	3.7	1.9	1.1	3.4	2.8	2.8	2.8	2.6	2.6	2.8	3.5	0.6	2.8
Revenue and grants	20.8	19.9	16.4			16.7	17.0	17.4	17.4	17.1	16.8		15.4	16.1	
of which: grants	4.6	3.6	1.5			1.8	1.8	1.8	1.8	1.8	1.8		1.3	0.4	
Primary (noninterest) expenditure	22.3	21.4	20.1			20.1	19.7	20.2	20.2	19.6	19.3		18.9	16.6	
Automatic debt dynamics	-4.4	-3.5	-4.3			-2.3	-3.3	-4.4	-4.5	-3.7	-3.5		-4.3	-3.4	
Contribution from interest rate/growth differential	-3.1	-3.5	-3.8			-3.3	-3.6	-4.4	-4.4	-3.8	-3.6		-4.4	-3.4	
of which: contribution from average real interest rate	0.9	0.4	0.0			0.4	0.3	-0.1	-0.1	0.5	0.8		0.2	0.1	
of which: contribution from real GDP growth	-4.0	-3.9	-3.8			-3.7	-3.9	-4.3	-4.3	-4.3	-4.3		-4.6	-3.5	
Contribution from real exchange rate depreciation	-1.3	0.0	-0.5			1.1	0.2	0.0	0.0	0.1	0.1		...	...	
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	4.6	1.7	1.4			1.4	4.8	2.3	1.9	2.9	3.1		-0.1	0.3	
Other Sustainability Indicators															
PV of public sector debt	...	...	45.0			47.4	52.1	53.6	54.8	56.6	58.7		64.0	54.1	
of which: foreign-currency denominated	...	...	33.1			35.5	36.6	36.5	36.0	35.6	35.1		31.0	27.5	
of which: external	...	...	33.1			35.5	36.6	36.5	36.0	35.6	35.1		31.0	27.5	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	7.8	7.8	10.0			10.1	9.9	11.1	11.9	12.3	13.1		17.4	9.6	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	274.3			284.3	307.1	308.0	314.7	332.0	350.3		414.0	336.8	
PV of public sector debt-to-revenue ratio (in percent)	...	...	301.8			318.0	343.6	343.5	350.7	370.8	392.1		452.4	346.1	
of which: external 3/	...	...	221.7			237.6	241.7	234.0	230.6	233.0	234.3		219.5	176.0	
Debt service-to-revenue and grants ratio (in percent) 4/	14.3	12.1	15.3			18.1	19.1	21.1	23.1	24.6	25.9		30.5	27.5	
Debt service-to-revenue ratio (in percent) 4/	18.4	14.8	16.8			20.2	21.4	23.6	25.7	27.4	29.0		33.3	28.3	
Primary deficit that stabilizes the debt-to-GDP ratio	-0.1	1.8	2.9			0.9	-1.5	2.2	2.6	0.8	0.4		4.5	3.0	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	7.6	7.3	7.0	7.7	0.3	6.8	6.8	7.0	7.0	6.9	6.8	6.9	6.6	5.7	6.2
Average nominal interest rate on forex debt (in percent)	3.4	1.9	2.1	1.6	0.8	2.6	2.4	1.6	1.7	3.1	3.7	2.5	2.6	2.8	2.7
Average real interest rate on domestic debt (in percent)	1.7	3.1	-1.2	-1.1	3.1	1.0	1.3	0.4	0.2	0.4	0.3	0.6	-0.1	-0.7	-0.2
Real exchange rate depreciation (in percent, + indicates depreciation)	-3.1	0.1	-1.1	-4.3	4.4	2.5	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	5.7	2.3	3.0	4.5	2.7	1.4	2.2	3.0	3.2	3.0	3.0	2.6	3.0	3.0	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-2.3	3.0	0.5	0.2	1.3	6.7	4.9	9.3	7.4	3.7	5.3	6.2	4.9	1.7	5.2
Grant element of new external borrowing (in percent)	...	...	...	...	...	20.6	20.1	19.3	19.2	19.6	19.6	19.7	17.8	17.1	...

Sources: Country authorities; and staff estimates and projections.

1/ Public sector debt statistics cover the central government gross debt.

2/ 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.

3/ Revenues excluding grants.

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

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

Table 3. Lao P.D.R.: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2017–37

(Percent)

	Projections							
	2017	2018	2019	2020	2021	2022	**2027**	2037
PV of debt-to GDP ratio								
Baseline	35	37	37	36	36	35	**31**	28
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	35	37	38	39	46	50	**58**	56
A2. New public sector loans on less favorable terms in 2017-2037 2/	35	38	39	39	40	40	**40**	44
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	35	36	36	36	35	35	**31**	27
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	35	38	42	42	41	40	**33**	28
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	35	36	36	36	35	35	**31**	27
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	35	38	39	38	38	37	**32**	27
B5. Combination of B1-B4 using one-half standard deviation shocks	35	34	32	32	31	31	**28**	26
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	35	52	52	51	50	50	**44**	39
PV of debt-to-exports ratio								
Baseline	102	108	107	106	122	123	**115**	92
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	102	109	112	116	156	177	**214**	187
A2. New public sector loans on less favorable terms in 2017-2037 2/	102	112	114	116	136	142	**150**	146
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	102	108	107	106	121	123	**115**	91
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	102	119	146	144	164	165	**146**	108
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	102	108	107	106	121	123	**115**	91
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	102	112	114	112	128	130	**118**	92
B5. Combination of B1-B4 using one-half standard deviation shocks	102	103	102	101	115	117	**112**	92
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	102	108	107	106	121	123	**115**	91
PV of debt-to-revenue ratio								
Baseline	238	242	234	231	233	234	**220**	176
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	238	244	243	251	299	336	**407**	358
A2. New public sector loans on less favorable terms in 2017-2037 2/	238	250	249	252	261	270	**286**	280
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	238	240	231	228	230	231	**216**	174
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	238	252	271	266	268	267	**236**	176
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	238	239	232	228	231	232	**217**	174
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	238	251	248	244	246	246	**225**	175
B5. Combination of B1-B4 using one-half standard deviation shocks	238	225	206	203	206	207	**199**	164
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	238	342	331	326	329	331	**310**	249

Table 3. Lao P.D.R.: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2017–37 (concluded)

(Percent)

Debt service-to-exports ratio								
Baseline	8	8	9	10	12	13	**14**	13
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	8	8	9	9	11	12	**19**	17
A2. New public sector loans on less favorable terms in 2017-2037 2/	8	8	8	8	9	11	**14**	19
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	8	8	9	10	12	13	**14**	13
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	8	9	11	13	15	17	**19**	15
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	8	8	9	10	12	13	**14**	13
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	8	8	10	11	13	14	**15**	13
B5. Combination of B1-B4 using one-half standard deviation shocks	8	8	9	10	12	13	**14**	13
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	8	8	9	10	12	13	**14**	13
Debt service-to-revenue ratio								
Baseline	18	19	20	22	24	25	**27**	24
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	18	18	19	20	21	23	**35**	33
A2. New public sector loans on less favorable terms in 2017-2037 2/B70	18	19	17	18	18	21	**27**	36
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	18	19	20	22	23	25	**27**	24
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	18	19	21	24	25	27	**30**	25
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	18	19	20	22	24	25	**27**	24
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	18	19	21	23	24	26	**28**	24
B5. Combination of B1-B4 using one-half standard deviation shocks	18	18	19	21	22	22	**24**	23
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	18	27	29	32	34	35	**38**	35
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	12	12	12	12	12	12	**12**	12

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 2017–2037

	Projections							
	2017	2018	2019	2020	2021	2022	2027	2037
PV of Debt-to-GDP Ratio								
Baseline	47	52	54	55	57	59	64	54
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	47	51	51	51	52	54	51	37
A2. Primary balance is unchanged from 2017	47	53	55	56	59	62	65	63
A3. Permanently lower GDP growth 1/	47	52	54	55	57	59	65	56
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	47	52	53	54	56	58	63	52
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	47	52	54	55	57	59	64	54
B3. Combination of B1-B2 using one half standard deviation shocks	47	51	52	54	55	57	62	51
B4. One-time 30 percent real depreciation in 2018	47	67	67	67	68	70	73	64
B5. 10 percent of GDP increase in other debt-creating flows in 2018	47	61	62	63	64	66	70	58
PV of Debt-to-Revenue Ratio 2/								
Baseline	284	307	308	315	332	350	414	337
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	284	300	296	296	308	321	330	231
A2. Primary balance is unchanged from 2017	284	310	314	324	345	367	424	391
A3. Permanently lower GDP growth 1/	284	307	309	316	333	352	420	351
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	284	305	305	311	328	345	406	326
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	284	308	310	317	334	352	416	338
B3. Combination of B1-B2 using one half standard deviation shocks	284	304	302	308	324	342	401	320
B4. One-time 30 percent real depreciation in 2018	284	393	385	386	401	416	474	398
B5. 10 percent of GDP increase in other debt-creating flows in 2018	284	359	356	361	377	394	451	360
Debt Service-to-Revenue Ratio 2/								
Baseline	18	19	21	23	25	26	30	28
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	18	19	21	22	23	25	25	16
A2. Primary balance is unchanged from 2017	18	19	21	23	25	26	32	30
A3. Permanently lower GDP growth 1/	18	19	21	23	25	26	31	29
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	18	19	21	23	24	26	30	27
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	18	19	21	23	25	26	31	28
B3. Combination of B1-B2 using one half standard deviation shocks	18	19	21	23	24	25	30	26
B4. One-time 30 percent real depreciation in 2018	18	23	29	32	34	36	46	49
B5. 10 percent of GDP increase in other debt-creating flows in 2018	18	19	23	25	26	28	35	30

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 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 7, 2018

Prepared By

Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of December 31, 2017)

Membership Status: Joined on July 5, 1961.

General Resources Account:

	SDR Million	Percent Quota
Quota	105.80	100.0
Fund holdings of currency (Exchange Rate)	92.58	87.50
Reserve Tranche Position	13.23	12.50

SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	50.68	100.00
Holdings	37.83	74.65

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				
	2018	2019	2020	2021	2022
Principal					
Charges/Interest	0.10	0.10	0.10	0.10	0.10
Total	0.10	0.10	0.10	0.10	0.10

[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 a managed float. Since September 2016, the kip has followed a depreciating trend against the U.S. dollar. Therefore, the de facto exchange rate arrangement was reclassified to a crawl-like arrangement from a stabilized arrangement, effective September 2, 2016. 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 previous 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.

Lao P.D.R. has accepted the obligations under Article VIII, Sections 2(a), 3 and 4 and maintains an exchange system free of restrictions on the making of payments and transfers on current international transactions, except for restrictions imposed solely for security reasons and notified to the Fund under the Decision No. 144-(52/51).

Article IV Consultation

The last Article IV consultation discussions were held in Vientiane during September 19–30, 2016 and were concluded by the Executive Board on January 30, 2017. The staff report (Country Report No. 17/53) was published February 2017.

Technical Assistance

Over the past five years, Lao P.D.R. has received technical assistance in the areas of: banking supervision and interbank market development; monetary operations; customs administration; tax and natural resource revenue administration; tax policy; public financial management; macroeconomic management; price statistics; external sector statistics; government finance statistics; and the national accounts. A Bangkok-based IMF office, TAOLAM, was set up in September 2012 to facilitate technical assistance to Lao P.D.R. (as well as Cambodia, Myanmar and Vietnam) and has provided technical assistance in macroeconomic analysis and forecasting, monetary operations, government finance statistics, external sector statistics, and public financial management.

Resident Representative

Jonathan Dunn assumed the Resident Representative post for Vietnam and Lao P.D.R., based in Hanoi, on October 16, 2015.

IMF-WORLD BANK COLLABORATION

The World Bank and the IMF country teams for Lao P.D.R. met on December 4, 2017 to discuss economic issues and outlook and to coordinate the two teams' work for FY2018. The teams were led by Mr. Evgenij Najdov (Senior Country Economist, Macro and Fiscal Management Global Practice, World Bank), and Mr. Geoffrey Bannister (IMF Mission Chief for Lao P.D.R.).

The teams agreed that although Lao P.D.R. has made progress on macroeconomic stabilization, significant vulnerabilities remain. More efforts could be made to reduce external vulnerabilities and restore fiscal sustainability. Improved tax base, tighter fiscal, a more flexible exchange rate and strengthened banking supervision will be needed to build international reserves and ensure macrofinancial stability. In the longer run, a key challenge is to promote inclusive growth and poverty reduction through more diversification into non-resource sectors, non-electricity sector, and sustainable development of natural resources. Progress has been made in recent years on product and labor market openness and poverty reduction. Further trade integration will improve the business climate, and promote private investment and institutional reform. Upgrading health and education infrastructure and improving outcomes will raise the growth potential and help reduce inequality. IMF-World Bank collaboration remains good with frequent and productive consultations and engagement between the teams.

Table 1. Lao P.D.R.: World Bank Group and Fund Planned Activities in Macro-Critical Structural Reform Areas, November 2017–December 2018

Title	Products	Provisional Timing of Missions	Delivery Date
1.World Bank Program	Green Resilient Growth Development Policy Operation (GGDPO)	Development policy operations series of three operations (GGDPO2 identification mission proposed in March 2019)	Implementation throughout fiscal year. GGDPO1 approved in May 2017, GGDPO2 Board discussion expected in FY19
	Lao PDR second Trade Development Facility project (TDF2), Advisory Services to support Investment Climate, Lao PDR Competitiveness and Private Sector Development Project (under preparation)	Ongoing	TDF2 received additional financing and extension to September 2018; Advisory Services planned until December 2019; Competitiveness and Private Sector Development Project Board approval expected in FY19
	Public Finance Management Modernization Program (TA), including support on tax administration issues.	Ongoing	Implementation throughout September 2018; follow-up TA activity being considered.
	Hydro-Mining Technical Assistance Project	Ongoing	Implementation throughout FY18 with project closing in September 2018, follow-up TA on Sustainable Energy and Extractive Development combined with a Lao-Vietnam Interconnector project being considered for FY20
	Technical assistance to the financial sector on improving: the regulatory framework, financial soundness indicators, financial infrastructure including payment systems, accounting & auditing standards, deposit insurance, and insolvency & creditor rights.	Ongoing	Implementation throughout FY18
	SME Access to Finance lines of credit and technical assistance	Ongoing	Implementation throughout FY18
	Lao Statistical Capacity Building Project (LAOSTAT) (focus on economic statistics and macro framework in coordination with IMF TA below)	Ongoing	Project closing in February 2018; follow-up project considered with potential Board approval in FY19.
	Analytical work: macroeconomic monitoring (Lao economic monitors, Public Expenditure Analysis looking at debt management, civil service management and expenditure arrangements in health and education)	Ongoing	Implementation throughout FY18

Table 1. Lao P.D.R.: World Bank Group and Fund Planned Activities in Macro-Critical Structural Reform Areas, November 2017–December 2018 (concluded)

2. IMF Work Program[3]	Periodic staff visits by IMF HQ team and resident representative based in Hanoi	Ongoing	Twice a year for HQ team and monthly for resident representative
	Technical Assistance on monetary policy operation	Completed	September 2016
	Technical Assistance on bank-supervision and regulations	Completed	November 2016
	Technical Assistance on national accounts statistics	Completed	January 2017
	Technical Assistance on consumer prices/producer prices	Completed	March 2017
	Technical Assistance mission on Customs administration	Ongoing	Implementation throughout FY18
	Technical Assistance mission on tax administration	Ongoing	Implementation throughout FY18
	Technical Assistance on government financial statistics	Ongoing	Implementation throughout FY18
	Technical Assistance on external sector statistics compilation	Ongoing	Implementation throughout FY18
	Article IV Consultation	September 2016	Board discussion January 2017
	TAOLAM assistance on Government Finance Statistics (GFS)	Regular staff visits	Implementation throughout FY18
	TAOLAM on public financial management - implementation of the cash-based IPSAS	Regular staff visits	Implementation throughout FY18
	TAOLAM on macroeconomic management	Regular staff visits	Implementation throughout FY18

[3] FY 2017, May 2016 - April 2017.

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

The Asian Development Bank (ADB) country partnership strategy (CPS), 2017–2020 for the Lao People's Democratic Republic is in line with strategic directions of the government's eighth National Socio-Economic Development Plan 2016–2020. It will support inclusive and sustainable growth through three strategic priorities: (i) infrastructure and private sector development to support employment and income generation, (ii) enhanced human development, and (iii) sustainable natural resource management and climate resilience. Gender equity and governance are crosscutting themes. The focus will shift from sector selectivity toward more value added strategic interventions that build synergies across operations. The CPS aims to maximize efficiency and sustainability through larger operations implemented over a longer period; maximize synergies with the implementation of Greater Mekong Subregion (GMS) strategic framework 2012–22; and also increase responsiveness to emerging issues in a rapidly changing economy. The biannual allocation for 2017-2018 is $236.6 million grant, including $89.0 million from regional set aside and $9.36 million from Disaster Risk Reduction Fund.

As of end-2017, active loans/grants were worth US$769.972 million, of which US$291.951 million had been disbursed. During 2017, contract awards totaled US$95.971 million and disbursement was US$64.506 million. ADB approved two new loan projects and three new technical assistance (TA) projects for a total of US$45.6 million and US$3.8 million in 2017 respectively, including Northern Rural Infrastructure Development Project (additional financing), Trade Facilitation: Improved Sanitary and Phytosanitary Handling in Greater Mekong Subregion Trade Project (additional financing); TA projects related GMS Northern Cross-Border Power Trade and Distribution, Sustainable Rural Infrastructure and Watershed Management Sector Project and Support Economic Policy for Enhancing Productivity and Employment.

Lao P.D.R.: Asian Development Bank Commitments and Disbursements 2005-2017 1/

(In millions of U.S. dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017 2/
Commitments	87.0	60.7	47.4	46.6	81.2	55.3	53.2	73.7	102.6	80.1	67.7	65.7	96.0
Disbursements	78.7	76.8	74.8	56.9	75.9	61.5	73.2	68.6	76.4	78.9	65.8	56.1	65.4

Source: Data provided by the Asian Development Bank.

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

2/ The commitment and disbursements were estmiated for 2017.

STATISTICAL ISSUES

(As of January 17, 2018)

I. 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 mostly due to lack of capacity which could be addressed through further efforts on the part of the authorities involved. The IMF is conducting technical assistance (TA) and training programs to address the specific needs with a focus to mitigate near-term risks, 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. Rebased national accounts (base year=2012) were released in early 2017 with the help of a World Bank expert, broadly following the *System of National Accounts (SNA) 1993 (includes part of 2008 SNA)*. Lao P.D.R. participated in the IMF's Statistics Department (STA) project to implement the SNA and International Comparison Project (ICP), funded by the government of Japan through the Japan Administered Account for Selected Activities (JSA), and has received technical assistance (TA) to improve annual national accounts and develop quarterly national accounts (QNA). Under this project, Lao PDR made some methodology improvements in the annual GDP by activity estimates, and has moved closer to completing a new annual expenditure measure of GDP and a preliminary GNI series. However, there are some weaknesses in data sources, particularly on intermediate consumption of businesses. Some progress had also been made toward the development of a new quarterly GDP series and is expected to be finalized by mid-2018, together with GDP by expenditure.
Price Statistics: The monthly consumer price index (CPI) for Lao P.D.R. was updated during 2016. Coverage was extended from 12 to all 18 provinces, the number of basket items increased from 245 to 485, and expenditure weights were updated using the results of the 2012 Lao Social Indicator Survey (LSIS). However, the full list of the updated weights has not yet been disclosed. To ensure that the index remains representative of current expenditure patterns, the Lao Statistics Bureau should prioritize the update of the expenditure weights using the results of the 2017 LSIS. The producer price index (PPI) has not been released due to low survey response rates but dissemination is expected by mid-2018.
Government Finance Statistics: Government finance statistics remain weak. The current GFS data compilation procedures use various secondary data sources, resulting in internal inconsistencies and a lack of detail. Off-budget activities are not included in the fiscal data, although they have expanded rapidly in recent years. STA appointed a Government Finance Statistics (GFS) Advisor to the IMF Technical Assistance Office for the Lao PDR and the Republic of the Union of Myanmar (TAOLAM) in September 2014, whose activities are funded by the government of Japan. The main focus of the advisor is to assist the Ministry of Finance (MoF) in upgrading the compilation and dissemination procedures of fiscal data in line with the IMF's Government Finance Statistics Manual 2014 (*GFSM 2014*) and improve timely data dissemination to the IMF, as well as reduce fiscal data discrepancies. With assistance from the GFS expert, the

authorities submitted quarterly fiscal data for FY2015 to the IMF in December 2016 for inclusion in the Government Finance Statistics Yearbook and International Financial Statistics, but the timeliness needs significant improvement.
Monetary and Financial Statistics: The classification of monetary data by institutional sector and by financial instruments as well as valuation principles need to be strengthened. In addition, the timeliness of reporting needs further improvement. The latest monetary data reported to STA refer to December 2010. The compilation of monetary data based on Standardized Report Forms (SRFs) have yet to be introduced. The authorities recently requested blank SRF templates but data is yet to be submitted to STA
Financial Sector Surveillance: Lao PDR is yet to compile and submit to STA financial soundness indicators as recommended in the IMF FSI Guide.
External Sector Statistics: STA appointed an External Sector Statistics (ESS) Advisor to the Technical Assistance Office for Lao P.D.R. and Myanmar (TAOLAM) in February 2014. While significant room exists for improving the quality and coverage of balance of payments and external debt statistics in Lao PDR and for compiling data on the international investment position. TA has helped the BOL in modifying their estimation models for (1) imports cost, insurance, and freight – free on board; (2) outbound travel; and (3) compensation of employees and workers' remittances credits. Several components of balance of payments are missing due to the lack of source data. The BOL plans to disseminate the new time series in BPM6 format by March 2018. Implementation of the new international transactions reporting system (ITRS) is ongoing. The BOL does not yet compile an international investment position statement.
II. 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.

Lao P.D.R.—Table of Common Indicators Required for Surveillance

(As of December 29, 2017)

	Date of Latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]
Exchange Rates	12/29/2017	12/29/17	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	09/29/2017	11/28/17	M	I	Q
Reserve/Base Money	09/29/2017	11/28/17	M	I	Q
Broad Money	09/29/2017	11/28/17	M	I	Q
Central Bank Balance Sheet	09/29/2017	11/28/17	M	I	Q
Consolidated Balance Sheet of the Banking System	09/29/2017	11/28/17	M	I	Q
Interest Rates[3]	09/29/2017	11/28/17	M	I	M
Consumer Price Index	12/29/2017	01/12/18	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4]—General Government[5]	09/29/2017	12/06/17	I	I	I
Revenue, Expenditure, Balance and Composition of Financing[4]—Central Government	09/29/2017	12/06/17	I	I	I
Stocks of Central Government and Central Government-Guaranteed Debt[6]	12/29/2017	12/11/17	NA	NA	NA
External Current Account Balance	06/30/2017	11/28/17	Q	I	I
Exports and Imports of Goods and Services	06/30/2017	11/28//17	Q	I	I
GDP/GNP	12/29/2016	03/30/17	A	A	A
Gross External Debt	12/31/2017	11/28/17	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 Juda Agung, Executive Director for Lao People's Democratic Republic and Vatthana Sanoubane, Advisor to the Executive Director
February 26, 2018

1. The authorities would like to express their appreciation to the IMF mission team for the constructive policy discussions and comprehensive assessment during the 2017 Article IV consultation. They broadly agree with the staff appraisal and will thoughtfully consider staff's recommendations in steering policy measures to preserve macroeconomic stability.

2. The Lao economy continues to expand at a sustained and high annual average growth rate above 7 percent over the past decade, which has translated into commendable progress in poverty reduction, increased employment and favorable investment climate. Notwithstanding these encouraging developments, the authorities note that external and domestic challenges to the economic outlook remain, requiring continued commitment to fiscal consolidation, prudent monetary policy, financial stability and structural reforms. The implementation of such policy measures will ensure strong and sustainable growth and graduation from the least developed country status as set out in the National Socio-Economic Development Plan for 2016-2020.

Recent Economic Development and Outlook

3. **In 2017, growth registered at 6.8 percent underpinned by continued hydropower generation, construction and the ongoing Lao-China railway project.** This was marginally below the growth target of 7 percent due to lower commodity exports, tourist receipts and government measures towards sustainability such as the suspension of log export and expenditure restraint. Inflation in 2017 was 0.8 percent reflecting the decline in food prices and moderation of domestic demand. Higher electricity and manufacturing exports helped narrow current account deficit to 13 percent of GDP while FDI remained healthy in natural resource sector and special economic zones. Reserves at the end of 2017 stood around USD 1 billion and covered 4.5 months of imports, representing an adequate buffer to external shocks.

4. **Looking at 2018, the authorities have set the minimum growth target of 7 percent, supported by expected electricity output from new capacity coming on stream and tourism activities stemming from "Visit Lao" initiative. Inflation is projected to be manageable at below 5 percent.** Continued efforts will be made in mobilizing revenue, improving the legal framework, enhancing tax compliance and strengthening fiscal discipline. In this connection, the authorities target the fiscal deficit to be less than 5 percent of GDP. The current account deficit is projected to narrow further with the increase in exports and tourism receipts. The authorities also remain positive about FDI inflows and are determined to enhance the business environment which will support economic diversification and strengthen reserves. The medium-term outlook will remain broadly positive on the back of gradual improvements in the macroeconomic framework but the authorities note that uncertainties in the regional and global contexts could affect external demand and investments.

Fiscal Policy

5. **Tax administration has been strengthened with technical support from the Fund and development partners. Precisely, the authorities have completed an organizational restructure by putting the local tax authorities under the Tax Department in headquarter.** The enterprise survey is also underway to explore the scope for broadening the tax base. Point of Sale (POS) technology has also been rolled out into strategic retail stores to improve intelligence and tax compliance. Building on the recent success in requiring road tax payment via the banking system, a similar modernization approach will be further expanded. On customs revenue, rigorous measures have been put in place to counter smuggling and stem revenue leakage. At the same time, the authorities have also been working with custom authorities in neighboring countries to closely monitor import activities. Exemptions will also continue to be strictly implemented according to items listed under the Law on Investment Promotion.

6. **Besides ongoing measures to discontinue off-budget expenditure, the authorities will strictly enforce the Prime Minister's Order on economizing and eliminating non-essential outlays.** They will also continue to prioritize investment projects with credible and highest rates of return while improving the existing management framework. At the same time, current expenditure will be controlled through civil service reform to lower recruitment quota. In the medium term, the authorities target a reduction in the wage bill from 55 percent to 40 percent of total spending.

7. **Public debt level remains high but most of the debt is long-term and concessional and therefore manageable.** To ensure the sustainability and appropriate management of public debt, the Law on Public Debt Management will be tabled at the National Assembly (NA) in 2018. Its core elements are the statutory public debt ceiling of 65 percent of GDP and a requirement for NA approval of investment projects with value above USD 50 million. While commercial loans remain restricted to financing hydropower projects with FX income, the authorities emphasized that further borrowings will be pursued on concessional terms to support necessary investments.

8. **The authorities agree with staff on the importance of establishing a public debt anchor but have reservations about the target level of 50 percent of GDP and deficit requirement of 2.6 percent of GDP in medium term.** They recognize that adequate time is required for fiscal adjustments to yield desirable results as significant needs remain in financing poverty reduction. The authorities therefore consider that a medium-term debt target of 55 percent to GDP to be more realistic in reducing the risk of debt distress and strengthening the external position.

Monetary and Exchange Rate Policy

9. **The stable exchange rate has served as an effective anchor for inflation and has restored confidence in the local currency.** The authorities see merit in staff's

recommendation of allowing gradual depreciation of the exchange rate in the near term but are concerned that the depreciation could raise inflationary pressures and currency substitution may arise, as experienced in the past. Nevertheless, the currently low inflation environment has allowed the authorities to relax the exchange rate movement in line with market forces and within the target band. While believing that the current managed-float regime remains appropriate and supportive to a stable macroeconomic environment, the authorities also agree with staff that a more flexible regime is desirable when preconditions are in place to support the transition.

10. **While remaining supportive of market-based interest rates, the Bank of Lao PDR (BoL) noted with concern on 2015 surge in lending rates into the double-digits, stemming from competition amongst banks to mobilize deposits.** Interim measures were introduced to guide commercial banks in lowering interest rates to more appropriate levels with the objective of reducing borrowing costs and promoting access to finance for SMEs. Going forward, the authorities will closely monitor credit developments and with an eye to reversing the measure when market conditions permit.

11. **Recognizing that a high degree of dollarization limits the ability to implement effective monetary policy, the authorities have constantly endeavored to promote greater use of the local currency (kip).** In addition to inflation and exchange rate stabilization, the authorities have employed a multipronged strategy ranging from a kip promotional campaign, the introduction of deposit insurance, raising FX reserve requirements as well as legal enforcement on domestic transactions to be based in kip. As a result, dollarization, as measured by foreign currency deposit to broad money, has gradually declined from its peak of 80 percent in late 1990s to 42.4 percent in 2016. To move forward in de-dollarization, the authorities will promote the ease of mobile banking services and payments to play a greater role in kip transactions as well as reducing cash in the economy.

Financial Stability

12. **Overall, the banking sector remains sound and stable as the system-wide capital adequacy ratio is maintained above 15 percent and NPLs are around 3 percent.** The undercapitalized state-owned commercial banks are now undergoing internal restructuring while the BoL is carefully considering options for privatization. Beginning from 2017, the authorities have tightened due diligence and prudential requirements, leading to the recent decline in credit dollarization, however FX loan remains available to entities with FX earnings and strategic imports.

13. **The Regulatory framework is regularly reviewed and updated to better align with current developments and international best practices.** This includes the Laws on Commercial Banks and the Central Bank, which are being revised in consultation with the World Bank. The Regulation on Loan Classification and Provisions issued in 2011 remains an effective tool to accurately capture the problematic loans. Banks' stress testing will be conducted with a key focus on liquidity and credit risk while an early warning exercise will

be devised as part of the development of crisis management framework. To this end, the authorities are also implementing Fund and World Bank advice in improving Financial Soundness Indicators to effectively monitor the health of the banking system.

14. **Significant progress has been made in transforming the supervisory framework towards risk-based supervision and Basel II compliance.** The authorities have been appreciative of MCM technical assistance in migrating from compliance-based to risk-based supervision as well as developing manuals for onsite examination and offsite supervision. On Basel II, a Master Plan has been recently adopted to guide institutional set up during the transition period. A key task in 2018 will be requiring all banks to complete their internal gap analysis to comply with the new minimum capital requirement. The target for full-fledged Basel II compliance will hinge upon the progress in addressing the identified gaps.

Structural Reforms

15. **The authorities are aware of the country's narrow domestic production and export base and note that structural reform is necessary to move towards more broad-based growth.** Despite the gradual expansion in the services sector and commercialization of agricultural products, crucial tasks remain in creating a sound business environment and promoting the role of the SME sector to enhance its capacity to manufacture and export. Given this background, the authorities are determined to streamline business and property registration, enhance legal enforcement and create a level playing field. In a similar vein, any administrative bottlenecks that create additional cost for starting and doing business will be addressed. To press ahead with these reforms, the Prime Minister, earlier this month issued an executive order, calling on line ministries to address deficiencies identified in the World Bank's Ease of Doing Business indicators. The Law on Investment Promotion has also been amended to create more favorable incentives for projects invested in strategic zones.

16. **As approved by the government, the authorities are currently drafting the Strategic Plan on Restructuring SOEs.** Key reform areas will include equitization, employing professional management, and improving accounting standards, which aim at enhancing profitability, transparency and minimizing the burden to the government's balance sheet. The plan will also identify targeted SOEs with a clear strategy for restructuring process while aiming at lowering the number of SOEs and government's shares to a more appropriate level in medium term.

17. **The authorities will continue to focus on the improvement of the health and education sectors and social protection to enhance progress in poverty reduction and strengthen productivity and capacity.** Greater attention will be directed to people in rural areas to make growth more inclusive. In this regard, the authorities have announced a plan to gradually increase budget allocation in coming years to develop necessary infrastructure and capacity in the health and education sectors. Building on the progress made in achieving the Millennium Development Goals (MDGs), the authorities are committed to achieving Sustainable Development Goals (SDGs) especially with regards to the social and

environmental aspects of the country's development.

Conclusion

18. **The authorities are mindful of the considerable challenges to achieving targeted growth and sustainable development.** While acknowledging the likelihood of lower growth prospects, the authorities emphasize the need to address structural weaknesses and create a solid foundation to support development goals going forward. It is also equally important for the authorities to improve people's living standard and to graduate from least-developed country status by 2020. In the near term, growth will be supported by continued fiscal consolidation, well-grounded monetary and exchange rate management and financial stability as well as greater competitiveness for SOEs. In this regard, the authorities extend their appreciation to Fund staff for continuous engagement through various technical assistance projects and invaluable policy advice. All recommendations will be carefully considered and appropriately implemented and sequenced to achieve desired policy outcomes.