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Lao People's Democratic Republic: 2005Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Lao People's Democratic Republic

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 2005 Article IV consultation with the Lao People's Democratic Republic, the following documents have been released and are included in this package:

- the staff report for 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 18, 2005, with the officials of the 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 22, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 8, 2006 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for the Lao People's Democratic Republic.

The document listed below will be separately released.

Selected Issues Paper and Statistical Appendix

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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LAO PEOPLE'S DEMOCRATIC REPUBLIC

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation
with the Lao People's Democratic Republic

Approved by Masahiko Takeda and Anthony Boote

February 22, 2006

- A mission visited Vientiane during November 7–18, 2005 for discussions on the 2005 Article IV Consultation and met with Minister of Finance Chansy Phosikham, Acting Bank of the Lao P.D.R. Governor Phouphet Khamphounvong, and other senior officials as well as representatives of the private sector and civil society.
- The staff team comprised Messrs. Bingham (head), Nakabayashi, and Syed (all APD), Mr. Mirzoev (PDR) and Ms. Mishra (FAD). Ms. Phang and Mr. Sitthilath (both OED), and Mr. Takeda (APD) also participated in the discussions. The mission was assisted by Mr. Beaugrand, the resident representative, and liaised closely with the World Bank and Asian Development Bank.
- The last Article IV consultation was concluded on November 29, 2004. Fund policy advice in recent years has focused on consolidating macroeconomic stability and advancing structural reforms to improve revenue mobilization and expenditure management, as well as strengthen the banking system. While there has been broad agreement on macroeconomic policies, which has contributed to an improved macroeconomic performance, progress in the structural area has been more difficult due to capacity constraints and a lack of consensus on reforms.
- Lao P.D.R.'s statistical data base has significant limitations for surveillance purposes (Annex IV). The Fund has provided guidance on the steps needed to participate in the General Data Dissemination Standard (GDDS) and the authorities are receiving assistance from Sweden (SIDA) to build up the capacity of the National Statistics Office and address weaknesses in their statistical systems.
- Lao P.D.R. maintains exchange restrictions imposed for the preservation of national or international security, which have been notified pursuant to Decision No. 144–(52/51), and a restriction subject to Fund approval under Article VIII (tax payment certificates are required for some transactions). Staff does not recommend approval of this latter restriction, and has advised the authorities to eliminate it before accepting the obligations under Article VIII.

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EXECUTIVE SUMMARY

Lao P.D.R.'s macroeconomic performance continued to be encouraging in 2005, but underlying fragilities remain. Macroeconomic conditions remained stable and growth was robust, driven by an expansion in the mining and hydro-power sectors. However, structural reforms remained slow, especially with regard to revenue mobilization, and directed credits at the state-owned commercial banks continue to pose a risk to macroeconomic stability.

The economic outlook is relatively favorable, if progress is made on structural reforms. The main risk to the medium-term outlook is that fiscal reforms will remain slow and tentative, undermining progress towards debt sustainability. In addition, a weak and under-developed banking system could pose a constraint on economic development. Sustaining high rates of growth will also require a concerted effort to advance trade reforms and improve the economy's investment climate.

Discussions focused on policy priorities for consolidating macroeconomic stability and laying the foundations for broad-based economic growth:

- ***Macroeconomic policies***. Discussions focused mainly on establishing a sound framework for the 2005/06 budget, based on realistic revenue targets and a sustainable expansion of the wage bill, and containing the impact of large directed credits at the state-owned commercial banks.

- ***Fiscal reforms.*** The focus has continued to be on advancing structural reforms to mobilize revenues and improve expenditure management. Progress on both fronts will involve strengthening collaboration with provinces, and ultimately necessitate a broader reform of center-province relations.

- ***Banking reforms.*** There is a need for accelerated progress in restructuring the state-owned commercial banks, including by exploring more actively the possibility of seeking joint-venture partners, and improving their regulatory framework. Further efforts are also needed to extend the coverage of bank supervision and improve the overall banking environment, by providing a more level paying field for all participants.

- ***Structural reforms.*** Private sector investment is needed to widen the resource base and diversify exports. In this context, further efforts are needed to strengthen Lao P.D.R.'s competitiveness, placing special emphasis on trade facilitation and reforms to the business climate.

An Ex Post Assessment (EPA) of performance under Lao P.D.R.'s PRGF and ESAF programs has been completed. The EPA concluded that the design of the programs had been broadly appropriate, but that slippages with regard to key structural reform objectives suggested that there had been insufficient government ownership.

I. Introduction

1. **Lao P.D.R.'s economic performance in recent years has been encouraging in many respects.** Macroeconomic conditions have been relatively stable, reflecting improved monetary and fiscal discipline, and economic activity has been robust—particularly over the last couple of years, when a number of large mining and hydro-power projects came on stream (Chart 1). The gradual integration of the economy with that of its fast growing neighbors has also brought substantial benefits and contributed to progress in reducing poverty (Annex V).

2. **However, significant challenges remain.** The macroeconomic situation is still fragile, as the underlying fiscal trends—with spending on wages and debt service outstripping revenue growth—are not sustainable, and directed credits at the state-owned commercial banks continue to pose a risk to monetary stability. Sustained economic development and poverty reduction also require reforms to improve Lao P.D.R.'s investment climate, as the large projects that are currently driving growth have few linkages to the rest of the economy (Box 1). There is also a need to improve the efficiency of public spending, as Lao P.D.R. remains one of the poorest countries in the world and its social indicators continue to lag far behind those of its neighbors in the region (Chart 2).

3. **The Article IV Consultation discussions were timely as the authorities were in the process of finalizing their next development plan.** The sixth national development plan (2006–2010), which will be presented to the Seventh Party congress in April, provides an opportunity to move the economic reform agenda forward, as there is a recognition that progress needs to be made in key reform areas such as mobilizing budget revenues and strengthening the state-owned commercial banks. However, the outlook for reform is uncertain. While there is a broad consensus on the basic development strategy, some of the underlying policies remain highly contentious, especially in the area of fiscal reform which touches upon the sensitive issue of center-province relations.

4. **Lao P.D.R.'s PRGF arrangement, approved in April 2001, lapsed in April 2005, with only three of six reviews completed** (Annex I). Although macroeconomic performance remained broadly on track, lack of progress on structural reforms and safeguards policies prevented completion of further reviews. The accompanying Ex Post Assessment (EPA) evaluates Lao P.D.R.'s performance under the PRGF and previous ESAF program, and draws lessons for future Fund engagement (see section E).

II. Recent Developments

5. **The economy performed well during 2005** (Table 1). Staff estimates that growth increased to 7 percent in 2005 from 6½ percent in 2004, driven mainly by an expansion in activity at the Oxiana gold and copper mine, and the construction of the Nam Theun 2 (NT2) hydroelectric dam. The stimulus from these large projects, combined with buoyant growth in tourism and non-traditional exports, more than offset the impact of the expiry of the

Box 1. Lao P.D.R.: Macroeconomic Impact of Large Projects

Lao P.D.R.'s medium-term outlook is significantly influenced by three large operations in the natural resource sector: the Nam Theun 2 (NT2) hydroelectric power project, whose construction commenced in mid-2005 and which is expected to begin exporting electricity in 2009; and Oxiana and Pan Australian, two foreign-owned gold and copper mining companies which began operations in 2004–05 and are expected to reach full capacity by 2007.

Growth and employment. While these large projects are expected to make significant contributions to growth over the next few years (on average, around 1½ percentage points per year during 2006–2010), this impact will ease as the mining projects reach full capacity and construction of the NT2 dam winds down.[1] Moreover, the projects have few linkages to the rest of the economy, and will not be a major source of employment generation.[2]

Balance of Payments. Although the projects are expected to nearly double merchandise exports by 2010, their net impact on the balance of payments is more modest. Net inflows are projected to average about 3 percent of GDP in 2005–2010. Over the next few years, a larger current account deficit, due to increased capital imports associated with the construction of NT2, is expected to be more than fully financed by capital inflows in the form of private NT2-related loans (Figure 1). This trend is projected to reverse around 2007, when an improvement in the current account due to a surge in mining (and later, electricity) exports will be offset by large capital outflows associated with the repayment of NT2-related loans and the repatriation of mining profits.

Budget. The large projects will generate additional budget revenues in the form of taxes, royalty payments, and dividends. These revenues are expected to increase from 0.2 to 1.3 percent of GDP between 2005 and 2010 (Figure 2). The fiscal impact is relatively modest for a project of its size (50 percent of GDP), because the revenue stream from NT2 is significantly back loaded—indeed revenues from NT2 are expected to remain below 1 percent of GDP until the end of the concession period in 2035. The government has agreed on a strategy with the major backers of the NT2 project to ensure that these revenues will result in increased spending on poverty reduction and environmental protection. To ensure this, the government has launched a major public expenditure initiative (PEMSP).

Overall assessment. While the large projects will generate a substantial impact on Lao P.D.R.'s "headline" macroeconomic indicators (growth, current account balance, etc.), their net impact on the economy will be more modest. This reflects the fact that they are externally-financed enclave projects which are largely insulated from the rest of the economy, and that the associated government revenue streams are also relatively moderate. Ensuring broad-based economic growth and continued poverty reduction will consequently depend mainly on the performance of the "underlying" economy.

Figure 1. Balance of Payments Impact of Large Projects

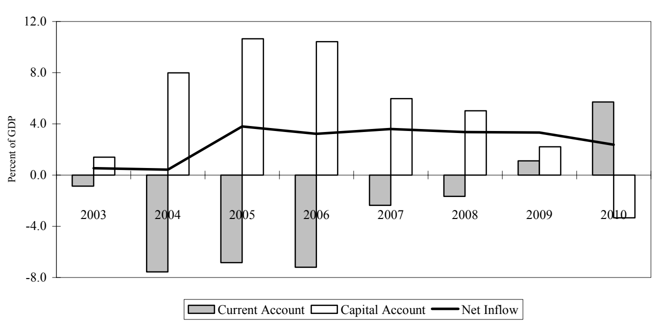
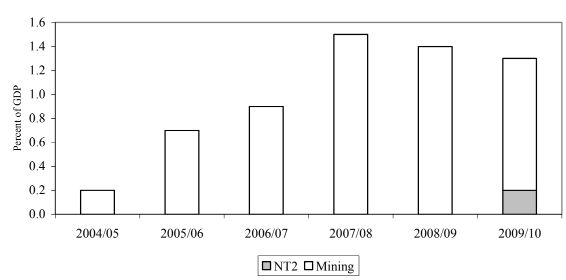


Figure 2. Fiscal Impact of Large Projects

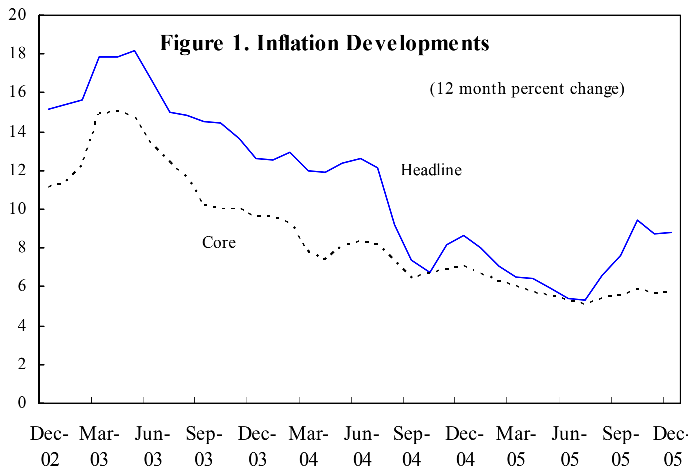


[1] There will be a large (2½ percentage point) one-off-jump in growth in 2010, when the NT2 project comes on stream.

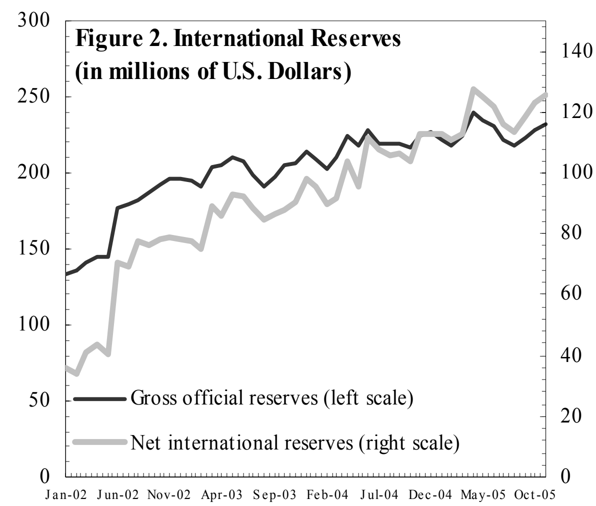
[2] The mining projects employ about 2,000–3,000 workers. The NT2 project will ultimately employ about 5,000–6,000 workers during the construction of the dam, but this will drop to a few hundred once the plant is commissioned.

Multi-Fiber Agreement (MFA) quota system and the sharp increase in international oil prices.[3]

6. **Inflation picked up in the middle of 2005, in the wake of a number of supply shocks, but underlying macroeconomic conditions remained stable.** The 12-month rate of inflation, which had been falling steadily for the past two years, rose sharply to 9.4 percent in October. The rise in inflation largely reflected an increase in rice prices, which were adversely affected by floods along the Mekong, and a large adjustment to domestic fuel prices.[4] Nevertheless, the Kip continued to trade in a relatively narrow band, and core inflation increased only modestly. With the upward trend in food prices starting to reverse, inflation fell back to 8.8 percent in December (Figure 1).



7. **The balance of payments has held up well in 2005, despite a number of adverse shocks, but a high external public debt remains an important vulnerability** (Table 2). A surge in mining exports helped offset the impact of higher oil prices and lower garment exports in 2005. Imports associated with the NT2 project caused the external current account deficit to widen to 16 percent of GDP, but this was offset by higher capital inflows. External reserves remained broadly unchanged, ending the year at around $230 million, or 3 months of imports (Figure 2). However, external public debt remains high, at close to 80 percent of GDP.[5]



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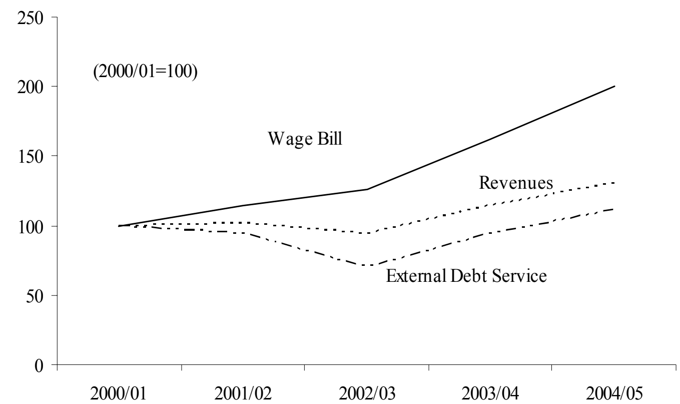
[3] Staff estimates that garment exports declined by 10 percent in 2005.

[4] Domestic fuel prices were raised by around 45 percent in 2005, as the government largely passed through the increase in international oil prices.

[5] The NPV of external public debt at end-2005 is estimated at 171 percent of exports.

8. **The government has kept tight control over the cash budget deficit, despite slow revenue growth and rising spending pressures** (Table 3). The latest data suggest that the budget deficit in 2004/05 was limited to 3½ percent of GDP, broadly unchanged from 2003/04. However, staff estimates that budget revenues, at 10.9 percent of GDP, were well below the revised budget target of 11.4 percent of GDP.[6] A reduction in the excise on diesel to mitigate the impact of higher oil prices, and delays in the implementation of tax measures (e.g., eliminating the third, concessional, rate of the turnover tax) were contributory factors, but weak revenue administration remains the key impediment to mobilizing revenues. With debt service and the wage bill rising significantly over the past two years, non-wage spending has come under increasing pressure (Figure 3).[7]

Figure 3. Recent Budget Trends (US$)



9. **The Bank of Lao P.D.R. (BoL) has maintained monetary stability, but credit developments at the state-owned commercial banks remain a concern** (Table 4). Net domestic assets of the BoL, which had expanded sharply in the first quarter of 2005, have since stabilized, and the rapid growth in Kip reserve money has moderated. However, credit growth at the state-owned commercial banks accelerated sharply in 2004/05 (35 percent), largely on account of large credits that the banks extended to two projects.[8] In addition to breaching the BoL's prudential regulations on single-borrower exposures and violating their governance agreements, these credits caused a significant tightening of the liquidity position of the two main state-owned commercial banks (BCEL and LDB). Both banks were having difficulty meeting their reserve requirements in the latter half of 2005.

10. **Progress on structural reforms has been mixed.** The government has taken a number of positive steps to strengthen the investment climate and move trade reform forward (see paragraphs 28 and 29). However, progress in core macroeconomic reforms has been

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[6] The authorities are reporting a higher revenue outturn (11.2 percent of GDP), but staff understands that this includes "accrued" revenues (e.g., provincial estimates of tax arrears).

[7] For example, the government is running arrears on its utility bills and does not have sufficient funds to distribute donor-funded vaccines.

[8] The two main state-owned commercial banks, BCEL and LDB, lent around $14 million to Thakek cement, a private cement project sponsored by the government. BCEL also contributed $10 million to an international syndicated loan for the Oxiana mine.

limited. While a new Customs law addressing a number of WTO-related issues (e.g., on customs valuation) was enacted and progress made in rolling out a new government financial information system (GFIS), the broader fiscal reform agenda is still stymied by a lack of consensus on how to strengthen the central government's control over provincial tax, customs, and treasury operations. On the banking side, the financial position of the state-owned commercial banks remains precarious[9] and the extension of large directed credits to the Thakek project has highlighted weaknesses in their oversight.

III. Economic Outlook

11. **Staff has updated its assessment of the economic and debt sustainability outlook, on the assumption that structural reforms will be accelerated** (Annex VI). In such a scenario, headline GDP growth is projected to stay at 6–7 percent, with underlying growth—i.e., excluding the effects of the large projects—being sustained at 5 percent.[10] In addition to the stimulus from the NT2 project and a continued expansion of gold and copper production, the scenario assumes that further integration of the economy into the region—driven by the ASEAN Free Trade Agreement (AFTA) and other regional initiatives[11]—will also raise growth, particularly in agriculture, tourism, and small-scale manufacturing.

12. **However, there are a number of risks to the outlook.** In the short-term, the main risk to macroeconomic stability stems from the fragile condition of the budget and the state-owned commercial banks. The possibility of a natural disaster—such as an avian flu pandemic—also poses a risk to economic prospects. Sustaining underlying growth at 5 percent over the medium-term will require concerted efforts to advance trade reforms and improve the economy's investment climate.[12] This will become increasingly important when the stimulus from the large projects starts to diminish towards the end of the decade. In the absence of progress on this front, underlying growth is projected to slow to around 3–4 percent, limiting the potential for employment generation and poverty reduction.

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[9] The capital deficit of the two main state-owned commercial banks stood at around 4 percent of GDP at end-2004.

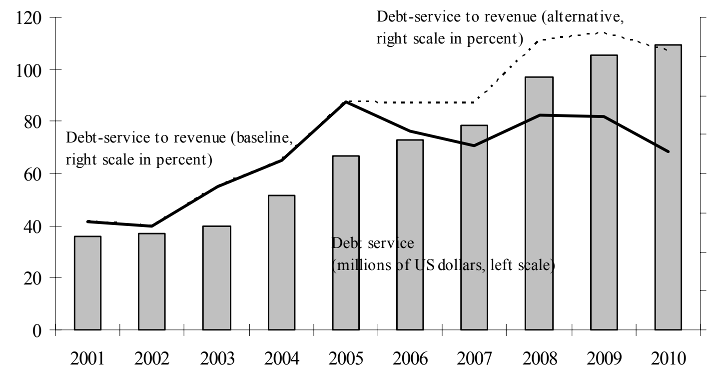
[10] This relatively positive outlook is less optimistic than the authorities' medium-term growth targets, which are in the range of 7–8 percent.

[11] Including the Ayeyawady-Chao Phraya-Mekong Economic Cooperation Strategy, which aims to promote investment, agriculture and tourism, and the AsDB's Greater Mekong Sub-Region program, which focuses on developing infrastructure and transport links.

[12] The contribution to growth from traditional exports such as timber and garments is expected to be modest.

13. **The medium-term public debt outlook also poses significant risks.** Even under staff's baseline scenario, in which revenues rise to 12.8 percent of GDP, debt service indicators remain high (Figure 4).[13] While increased royalties and taxes from mining will help boost revenues, the scenario also assumes an acceleration in reforms to domestic taxes, especially given the impending loss of customs revenues from tariff reductions under AFTA. Under an alternative scenario, in which the revenue effort stays unchanged at 11 percent of GDP, the outlook is less benign, with the debt service-to-revenue ratio continuing to rise significantly.

Figure 4. External Public Debt Service



IV. Report on the Discussions

14. **The discussions focused on the main macroeconomic policy priorities for the sixth development plan.** The authorities acknowledged that much remains to be done to consolidate macroeconomic stability and lay the foundations for broad-based economic growth. In addition to the long standing issues in fiscal management and the banking sector, the discussions focused on steps to improve the investment climate, which is essential for raising Lao P.D.R.'s growth potential.

A. Fiscal Policy

15. **The main short-term priority is to avoid an unsustainable expansion of spending, especially on the wage bill.** In this context, staff noted that the revenue target in the 2005/06 budget plan (11.9 percent of GDP) was overambitious and that the plan to further reduce non-wage domestic spending[14] was unlikely to be sustainable. To strengthen the budget plan, staff proposed that the authorities adopt a more conservative revenue target (11.6 percent of GDP), and limit the wage bill to 5.0 percent of GDP—rather than 5.2 percent in the budget plan—to alleviate the compression in non-wage spending in priority sectors. Staff also proposed that the budget deficit be reduced from 4.2 to 4.0 percent of GDP, at which level it would be fully financed by concessional donor financing.

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[13] The debt service-to-export ratio is less elevated, remaining in the range of 7 to 9 percent.

[14] Excludes donor-financed capital spending.

16. **The authorities agreed with the need to limit the growth in the wage bill, which had been rising rapidly in recent years.** To this end, they had decided not to award an increase in base salaries in 2005/06. They were planning to recruit an additional 8,000 employees for priority sectors (e.g., education and health), but were confident that they could limit the wage bill to 5.0 percent of GDP, provided that they managed to contain recruitment of contractual employees by the provinces. The authorities acknowledged some uncertainty in the revenue outlook, and agreed that it would be prudent to make the planned recruitment of additional staff conditional on a satisfactory revenue outturn in the first semester.

17. **The longer term challenge is to enable Lao P.D.R. to meet its substantial development needs within a sustainable fiscal framework.** In this regard, staff noted that the planned increase in the budget deficit over the medium-term to 4½ percent of GDP (or more)[15] did not appear consistent with the outlook for available ODA flows. Moreover, the staff's debt sustainability analysis suggested the need for some fiscal consolidation. Staff consequently proposed that the government aim to lower the budget deficit to 3–3½ percent of GDP over the medium-term, which would be consistent with reducing government debt to 65 percent of GDP by 2010.

18. **It was agreed that the main priority is to mobilize revenues.** While there is some scope for additional tax policy measures,[16] there is a consensus that the focus should be on improving tax administration, and that this will require strengthening central control over the administration of major taxes (e.g., customs and the turnover tax). The latter will ultimately need a broader reform of the decentralization framework (see paragraph 20), but there is potential in the interim for greater collaboration between the center and provinces, which could yield a significantly improved revenue performance. The discussions focused in particular on the following:

- **Incentives.** The new revenue bonus scheme proposed by the government could reduce the incentive of provinces to collaborate with the center in revenue mobilization. Under the new scheme, provinces would be required to remit all revenues in excess of their spending needs to center, in return for a small fee (0.5–1.5 percent of revenues collected). In staff's view, collaboration would be strengthened if the government retained the existing scheme of incentives, which allows the provinces to keep a significant share of any revenues collected in excess of their targets—provided these targets are set realistically (Box 2).

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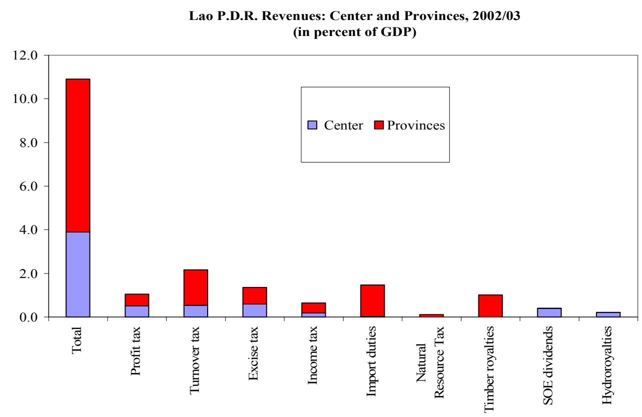
[15] The authorities indicated that the fiscal framework in their draft development plan had yet to incorporate additional allocations for priority sectors.

[16] The introduction of a VAT—currently scheduled for 2008/09—remains the main tax policy change in the medium-term. In the interim, there is scope for raising revenues through moving to a single-rate turnover tax and adjusting excises (especially on diesel and tobacco).

Box 2. Lao P.D.R.: Center-Province Fiscal Relations

Center-province relations have been a major issue on the fiscal reform agenda in Lao P.D.R. In particular, the fragmented administration of major taxes has been an important contributory factor to the poor revenue performance.

Current Situation[17]



Currently in Lao P.D.R., the majority of taxes are administered by the provinces. Each province is assigned revenue and expenditure targets that are formulated in the context of the annual national budget plan. In principle, surplus provinces are expected to remit their entire surplus to the center and deficit provinces are covered by transfers from the center.

Provinces whose revenue collections exceed their assigned targets are permitted to retain 50 percent of this excess revenue, with the balance remitted to the center. Provinces who fail to meet their revenue targets are expected to reduce their expenditures accordingly.

The system, however, does not work effectively for a number of reasons. First, the fragmentation of tax administration has severely compromised efforts to enforce tax compliance. The center's control over provincial operations is limited since the provinces have powerful support from regional factions within the party hierarchy. Moreover, civil servants in the provinces report predominantly to the Governor, who typically controls the payroll. Tax enforcement is also undermined by ad hoc exemptions granted by the provinces to promote investment in their regions. Second, the tendency towards overambitious revenue targets in the national budget plan has reduced the incentive of provinces to participate in efforts to mobilize revenues, as the possibility of provinces being able to outperform their targets (and retain some of the excess revenues) is effectively eliminated. Moreover, with provinces expected to remit all of the difference between their revenue targets and expenditure allocations, they have little incentive to collect more than their expenditure needs.

Regional Experience

Both China and Vietnam faced similar challenges and launched reforms to address weaknesses in their fiscal arrangements. These reforms were broadly successful in enhancing tax administration, boosting revenues, and increasing resources available to the center. This was achieved by (i) giving the center the authority to administer key taxes; and (ii) introducing a revenue sharing formula, which assigned taxes between the center and the provinces and incorporated a rules-based transfer mechanism. These experiences suggest that provinces can be persuaded to relinquish control over the administration of major taxes, provided that a credible framework for revenue sharing and government transfers is put in place. The experiences of China and Vietnam does, however, also suggest that more attention needs to be placed in the design stages to ensure that the transfer system is sufficiently equitable and transparent (as discussed in the Selected Issues Chapter).

[17] This describes the situation at the end of FY 2004/05.

- **Capacity building.** The main priority is to reduce the fragmentation in the administration of major taxes. On the customs side, implementing the new Customs Law, which clarifies the roles and responsibilities of the center and provinces, would be a step forward, as would establishing regional customs offices to oversee operations in the provinces. This would complement ongoing reforms to strengthen capacity at customs headquarters in Vientiane. On the tax side, the focus should be on improving oversight of large and medium taxpayers, through re-establishing a tax identification number (TIN) system initially in the national Large Tax Payer Unit and the three largest provincial tax offices. The TIN would form the basis of a tax reporting system for these offices.[18]

19. **Staff discussed progress under the Public Expenditure Management Strengthening Program (PEMSP), being supported by the World Bank.** The longer term goal is to establish a strong National Treasury with effective control over public finances.[19] Budget planning and execution are also to be strengthened to improve public service delivery. In the shorter term, the authorities have developed an annual implementation plan for the PEMSP for 2005/06, which would focus on the following key priorities: (i) revising the chart of accounts, to develop a functional classification that would enable the government to monitor expenditures in key activities (e.g., primary education); and (ii) extending the GFIS system to cover the center and all major provincial treasury offices.[20]

20. **The sixth development plan is expected to give greater prominence to the reform of center-province relations.** This reflects a recognition that there needs to be a clearer assignment of revenues and expenditures between the center and provinces, and a credible mechanism for revenue sharing and intra-governmental transfers. Provinces are unlikely to cede control over revenue and treasury operations until such a framework is in place. The authorities emphasized that this issue is highly sensitive, and that building consensus for reform was likely to take some time. However, they intend to initiate discussions with the provinces on reforms to center-province fiscal relations, which may be incorporated into planned revisions to the organic budget law.[21] Staff also noted that the experience of

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[18]The tax reforms are being supported by a technical assistance program from Sweden (SIDA). With expiration of UNDP's Customs project, the department is only receiving peripatetic support from the IMF.

[19] This would, inter alia, require a common pooling of national revenues and rationalizing the government's banking arrangements to bring them under the National Treasury's control.

[20] The objective is to produce regular budget execution reports for the center and provinces.

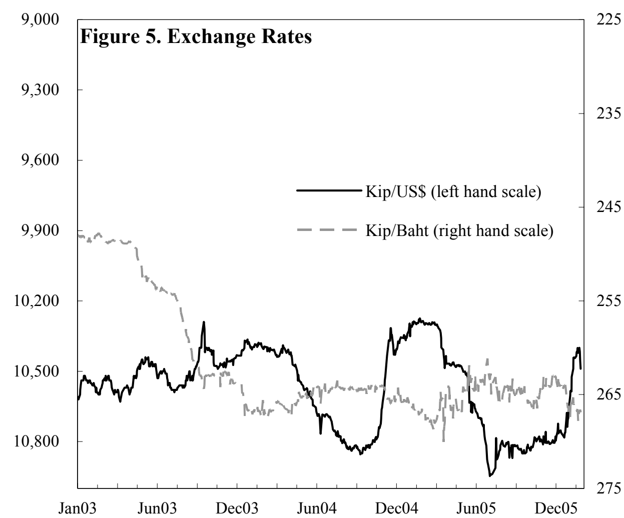
[21] The Ministry of Finance plans to finalize a revised draft of the budget law by the end of 2006.

neighboring countries (such as China and Vietnam), who had overcome similar challenges in raising their revenue effort, could provide valuable lessons for Lao P.D.R.[22]

B. Monetary and Banking Issues

21. **The authorities reiterated that policy would remain geared towards containing inflation and did not envisage any major changes in the monetary framework.** The broad aim would continue to be to keep the BoL's net domestic assets, the main anchor of monetary policy, relatively stable. This would be underpinned by a government commitment to avoid bank financing of the budget. The authorities expected the level of gross reserves to be maintained at around 3 months of imports, which would be consistent with reserve money growing at around 12 percent.

22. **Staff endorsed the authorities' basic approach to exchange rate management.** The current policy of keeping the Kip relatively stable has served Lao P.D.R. well in the past couple of years (Figure 5), with the authorities being able to smooth out most fluctuations in the exchange rate, without jeopardizing their reserve position.[23] Staff agreed that a more flexible Kip would be unlikely to materially affect Lao P.D.R.'s competitiveness, because of the high level of dollarization.[24] The authorities recognize that they only have the capacity to smooth out transitory fluctuations, and that exchange rate stability could ultimately only be preserved through prudent fiscal management and effective control over the state-owned commercial banks, both of which are central to monetary control.



23. **The authorities were aware of the risks posed by the large directed credits to the Thakek cement project.** They indicated that the state-owned commercial banks had been instructed to freeze further credits to the project and that the government was actively seeking a strategic investor to place the project's finances on a more sustainable footing. Staff welcomed these initial steps but emphasized the urgency of securing alternative sources

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[22] See Chapter I of accompanying *Selected Issues*.

[23] Exchange rate management has been sufficiently flexible to ensure that the parallel market premium has been kept at under 2 percent.

[24] Almost 70 percent of bank deposits are in foreign currency.

of funding, to avoid pressure on the banks to provide further credits to the project.[25] This experience has also highlighted the need for a coherent regulatory framework for single borrower exposures and stricter oversight by the BoL.

24. **The authorities indicated that they were rethinking some of the broader elements of their state bank reform strategy.**[26] In particular, they were beginning to explore more actively the possibility of seeking joint-venture partners for the banks, although they acknowledged that achieving consensus on this might take time. In the interim, the focus would be on improving and enforcing the governance agreements of the state-owned commercial banks, within the framework of the AsDB-supported state bank restructuring program. Staff supported the plan to start recapitalizing the banks, but urged the authorities to ensure that it be conditional on progress in their reform. Staff also encouraged the authorities to maintain a complement of international advisers in the banks until their operational restructuring was more advanced.

25. **Staff also encouraged the authorities to make further progress in strengthening the general banking system.** The main priority is to strengthen bank supervision. In addition to building up the supervisory capacity of the BoL and improving bank regulations to limit the scope of regulatory forbearance, supervision of private banks should be strengthened as they are not effectively covered at the moment.[27] Bankers also emphasized the need to strengthen contract enforcement mechanisms and ensure a level playing field, particularly with regard to differential capital requirements, the restrictions on opening branches outside of Vientiane, and the state bank monopoly on natural-resource related banking services.

C. External Debt Issues

26. **The mission discussed the potential implications of the Multilateral Debt Relief Initiative (MDRI) for Lao P.D.R.** The authorities noted that the MDRI would significantly reduce external public debt (Figure 6), but noted that the requirement to participate in the Enhanced HIPC Initiative could cause complications. In particular, the cash flow implications for the budget would be somewhat uncertain under such a scenario. In addition to a lower gross IDA allocation—a feature of the MDRI—participation in the HIPC Initiative would likely have ramifications for Lao P.D.R.'s relations with creditors and donors, particularly given their earlier commitments to creditors not to seek HIPC debt relief.

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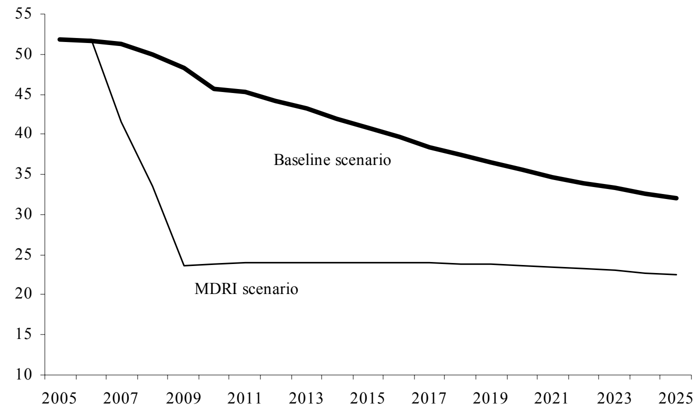
[25] Staff understands that further credits have since been provided, raising the banks' combined exposure to $30 million.

[26] See Chapter II of accompanying *Selected Issues*.

[27] This will also be important to bring Lao P.D.R. into line with international anti-money laundering regulations.

Figure 6. NPV of Debt-to-GDP
(in percent)



Consequently, while the MDRI had prompted some discussion within government, the authorities foresaw a number of obstacles to Lao P.D.R. participating in the two initiatives.

27. **The mission urged the authorities to continue efforts to strengthen public debt management.** Given the limited borrowing space, staff underscored the need to continue efforts to mobilize grants and highly concessional loans, and ensure that new funds are allocated to projects with the highest economic and social return. Borrowing on less concessional terms should be limited only to projects with firm financial viability. Establishing such viability in a transparent and credible manner would be important to maintain creditor confidence in government policies.

D. Structural Reforms

28. **Accelerating private sector development is a key objective of the government.** In addition to addressing Lao P.D.R.'s substantial infrastructure needs, which are being tackled by the AsDB and other donors, there has been an increased focus in recent years on improving the investment climate, which ranks poorly relative to neighboring countries. In this context, the main constraint on investors has been the absence of clear and predictable "rules of the game" for operating in Lao P.D.R. The approval of a New Enterprise law in 2005, which streamlines licensing and other regulatory requirements imposed on the business community, is a step forward, as the law, if fully implemented, should help reduce the cost (and uncertainty) of doing business in Lao P.D.R. However, more needs to be done to make laws and regulations less vague and open to discretion by officials.[28] Longer term there will also need to be a greater focus on developing the legal and judicial system to provide effective, rules-based, mechanisms for dispute resolution and contract enforcement.

29. **The authorities recognize that maintaining the momentum of trade reform will also be critical for developing the private sector.** They indicated that significant progress had been made in this respect over the past year. In addition to moving ahead with their commitments under AFTA, the government has signed an important bilateral agreement to normalize trade relations with the United States (NTR) and begun formal negotiations for WTO accession. They noted that import licenses at the central level were now limited to only

[28] These issues are discussed in greater length in the forthcoming *Diagnostic Trade Integration Study* prepared by the World Bank.

four products— fuel, cement, steel and vehicles— but acknowledged that more needed to be done to rein in additional regulatory requirements imposed by the provinces.

E. Ex Post Assessment of Program Engagement, 1993–2005

30. **The EPA team concluded that Lao P.D.R. had made significant progress under the ESAF and PRGF programs, but many challenges remained.** The team noted that economic growth had been strong, balance of payments stability had been restored, and poverty had been significantly reduced. Lao P.D.R. had also made good progress in its transition to a market based economy. However, the underlying macroeconomic situation remained fragile, because of weaknesses in the fiscal position and the large burden of external public debt. More also needed to be done to enhance the competitiveness of the economy, by improving the trade and investment regime. Strengthening public expenditure management to ensure a more effective use of fiscal resources towards poverty reduction was also a priority.

31. **The design and conditionality of the ESAF and PRGF programs were considered to have been broadly appropriate.** However, slippages with regard to key policy objectives on revenue mobilization, public sector financial management, and banking sector reform, suggested that there had been insufficient government ownership of reforms, especially under the PRGF program. The lack of progress on safeguards policies was an additional complication. While the staff had endeavored to correct the slippages in these areas, the EPA team considered that the program had appropriately been allowed to lapse after the third review was completed.

32. **The main challenge going forward would be to foster greater consensus for needed structural reforms, especially in the fiscal and banking areas.** Progress on the latter should be a precondition for any future Fund program. In the meantime, the EPA team was of the view that surveillance, combined with appropriately targeted technical assistance, would be the most appropriate form of engagement. Close and effective collaboration with donors would be essential in this regard.

33. **The authorities expressed broad agreement with the EPA report**. They considered that the general design and conditionality of the Fund programs had been well-suited to meet Lao P.D.R.'s needs, and that the programs had contributed to the economy's transition to a market-based system. Their main reservation was that the programs had, on occasion, focused excessively on stabilization objectives, without due consideration to the need to encourage investment and economic growth. They agreed that reforms in some areas fell short of program targets, and acknowledged the difficult challenges posed by Lao P.D.R.'s decentralized fiscal system. However, they thought that capacity constraints rather than lack of government ownership had been the most important factor in slowing the pace of reform. They consider Lao P.D.R.'s current engagement with the Fund, through surveillance and technical assistance, to be well-suited to the country's needs in the near term.

F. Data Issues

34. **There is a broad recognition that the quality of economic statistics needs to be improved for effective monitoring and policy formulation.** The main priorities are to strengthen the balance of payments, where the absence of reliable data is a major impediment to the analysis of economic developments. It is also the major constraint in the construction of a robust system of national accounts. Further strengthening of the quality of government finance statistics is also needed, especially at the provincial level. There is also a need to address weaknesses in the accounting systems at the BoL, which in addition to contributing to delays in finalizing the 2003 and 2004 audits, are also impeding effective monitoring of monetary and foreign exchange developments.

V. Staff Appraisal

35. **The economy's performance in 2005 continued to be relatively encouraging, but underlying fragilities remain.** Macroeconomic conditions remained stable and growth was robust, driven by an expansion in the mining and hydro-power sectors. The authorities maintained disciplined monetary and fiscal policies, but the pace of structural reforms to strengthen the budget and state-owned commercial banks continued to be slow.

36. **The economic outlook is favorable, if progress is made in structural reforms.** Growth should remain strong during the next few years, provided that the stimulus from the NT2 hydroelectric dam and the planned expansion in mining activity is complemented by reforms to facilitate private sector development and promote further trade liberalization. The external outlook is also reasonably buoyant, as these large resource projects should generate sizeable net balance of payments inflows. The main risk to the medium-term outlook is that the pace of reforms remains slow and tentative on the fiscal side, undermining progress towards debt sustainability. Without further reform, the state-owned commercial banks will also continue to pose a threat to macroeconomic stability.

37. **On the fiscal side, the immediate challenge is to avoid an unsustainable expansion of spending, especially on the wage bill.** In addition to having the 2005/06 budget based on more conservative revenue targets, steps should be taken to limit the growth in the wage bill to provide adequate resources for non-wage spending. The main priority is to rein in unauthorized recruitment of contractual employees by the provinces, but the planned recruitment of teachers and health workers should also be made conditional on a satisfactory revenue performance to ensure that it is sustainable. Staff also encourages the authorities to limit the budget deficit to no more than 4.0 percent of GDP, which would be consistent with available concessional donor financing.

38. **The medium-term priority is to mobilize revenues to enable Lao P.D.R. to meet its development needs within a sustainable fiscal framework.** This is especially important given the need for some fiscal consolidation over the medium-term to bring the level of debt down to sustainable levels. While an increase in mining revenues will make a contribution, reforms to strengthen central government control over provincial revenue and treasury

operations will need to be accelerated. This will ultimately require a broader review of center-province relations, as provinces are unlikely to cede control until a clear and credible revenue sharing framework is in place. However, the process of achieving consensus on this key reform is likely to take some time. In this context, the authorities' intention to hold discussions with the provinces is welcome and in the interim, greater collaboration with the provinces should be fostered, through providing an effective incentive structure, and capacity building efforts at the tax and customs departments should be advanced.

39. **Progress under the Public Expenditure Management Strengthening Program is essential to strengthen fiscal management and improve the allocation of public resources.** The main priorities in the short-run will be to improve budget reporting, inter alia by revising the chart of accounts, and strengthening budget monitoring by developing an effective reporting system covering key provincial treasury offices.

40. **Prudent debt management will be needed to mitigate the risks from Lao P.D.R.'s high debt burden.** This will be particularly important if Lao P.D.R. decides not to avail itself of the Enhanced HIPC Initiative and the Multilateral Debt Relief Initiative. In addition to maximizing grant funding and borrowing only on highly concessional terms, a gradual reduction in the public sector borrowing requirement will be needed to ensure progress in reducing the public debt burden.

41. **The current framework of monetary and exchange rate policy is appropriate, but oversight of the state-owned commercial banks needs to be strengthened.** The initial steps to limit the exposure of the banks to a large domestic cement project were appropriate, but there is an urgent need to find a strategic investor for the project to put its finances on a sustainable footing. Recent reports of further credits by the state-owned commercial banks to the project are of concern. The experience has also highlighted the need for a coherent regulatory framework for single borrower exposures.

42. **The authorities' intention to explore more actively the possibility of seeking joint-venture partners for the banks is welcome.** In the interim, the focus should be on strengthening the governance frameworks for the banks. Greater progress is also needed to improve bank supervision and strengthen the general banking environment, especially with regard to providing a more level playing field for new entrants.

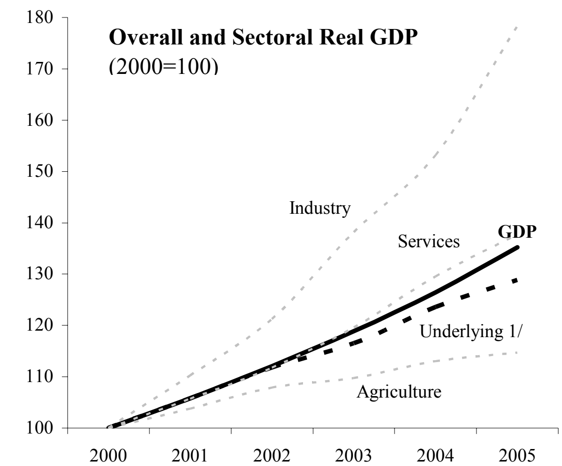
43. **The authorities have taken steps to improve the investment climate and promote trade, but more needs to be done.** The authorities' commitment to moving ahead with AFTA and starting the process of WTO accession is an important step towards integrating the economy into the regional and global markets. However, more needs to be done to improve the economy's competitiveness. In addition to reducing the cost of business by streamlining licensing and regulatory requirements, improving governance is a key priority, as the absence of clear and predictable "rules of the game" for operating in Lao P.D.R. is a major constraint for investors. The development of the legal and judicial system to provide effective, rules-based, mechanisms for dispute resolution and contract enforcement is an important longer term priority.

44. **Economic monitoring and policy formulation are being hampered by the poor quality of economic statistics.** The main priorities are to strengthen the balance of payments, where the absence of reliable data is a major impediment to the development of effective national accounts, and to improve the quality of government finance statistics, particularly at the provincial level. Weaknesses in the accounting systems at the BoL, which are impeding effective monitoring of monetary and foreign exchange developments, also need to be addressed.

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

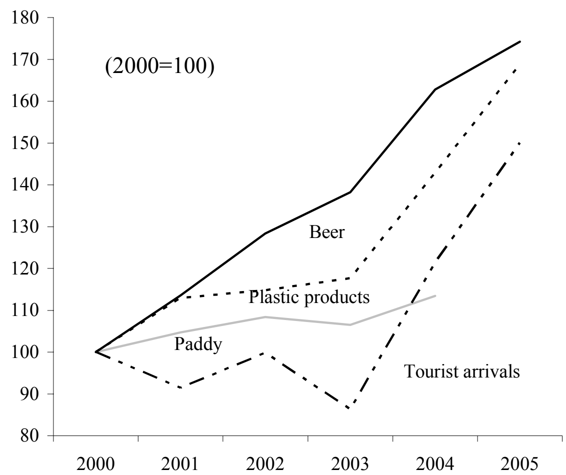
Chart 1. Lao P.D.R.: Selected Indicators of Economic Activity (2000-2005)

Growth has been robust —particularly towards the end of the period, with the onset of a number of large projects in the mining and hydroelectric sectors ...

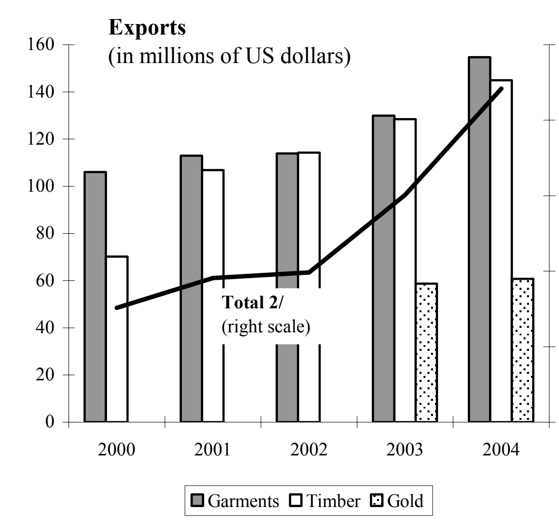


1/ GDP excluding impact of NT2 and large mining projects.

... as manufacuring output and services have expanded rapidly, offsetting the sluggishness in traditional agricultural products.

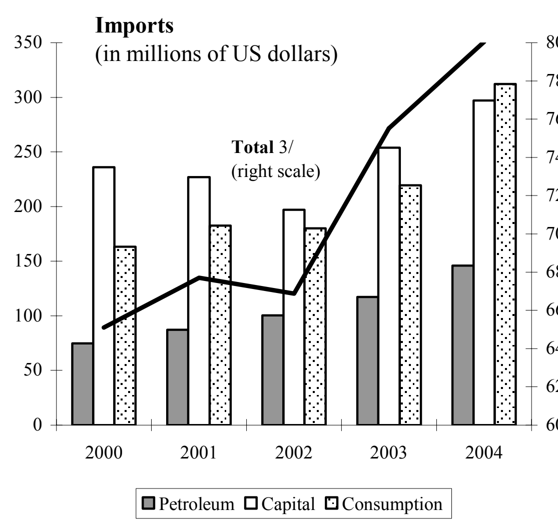


Growth has been supported by buoyant export performance in recent years...



2/ excluding electricity and gold.

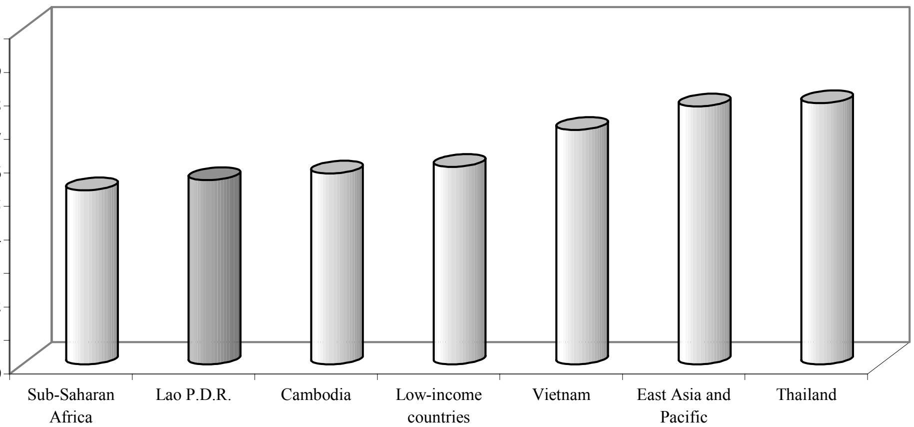
... and has been reflected in strong import growth over the latter half of the period.



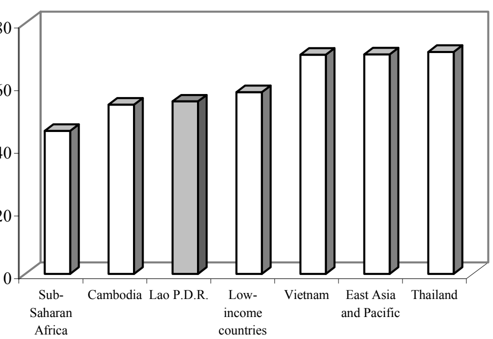
3/ excluding imports associated with NT2 and large mining projects.

Chart 2. Lao P.D.R.: Selected Development Indicators

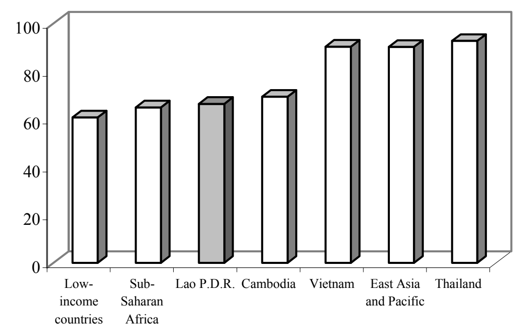
Human Development Index (HDI)



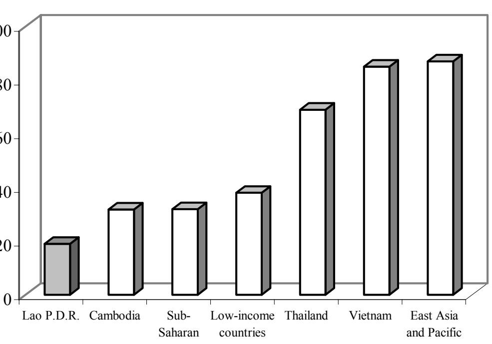
Life expectancy at birth (years)



Adult literacy (%)



Births attended by skilled health staff (%)



Access to an improved water source (%)

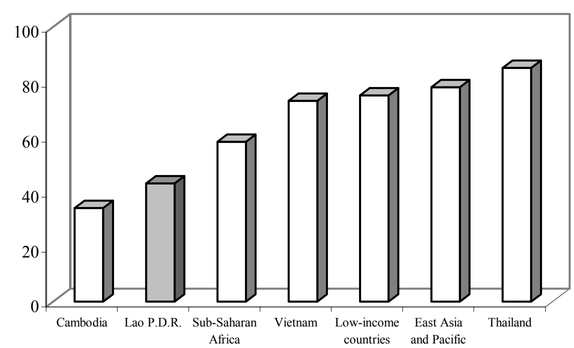


Table 1. Lao P.D.R.: Selected Economic and Financial Indicators, 2001-2006

Nominal GDP (2004): $2,451 million
Population (2004): 5.79 million 1/
GNI per capita (Atlas method, 2004): $390

	2001	2002	2003	2004	2005	2006
					Projection	
Real GDP growth (percentage change)	5.8	5.9	6.1	6.4	7.0	7.1
Inflation (annual percent change)						
Period average	7.8	10.6	15.5	10.5	7.2	6.8
End of period	7.5	15.2	12.6	8.7	8.8	5.0
Government budget (in percent of GDP) 2/ 3/	11.5	10.7	9.5	9.9	9.8	10.1
Revenue	13.2	13.1	10.9	11.0	10.9	11.6
of which: resource 4/	1.7	2.4	1.3	1.1	1.2	1.5
Grants	3.1	2.0	2.1	1.1	1.4	1.5
Expenditure	20.7	18.4	18.6	15.5	15.9	17.1
Overall balance (including grants)	-4.4	-3.3	-5.7	-3.4	-3.5	-4.0
Government debt	99.2	101.7	95.7	84.6	77.3	73.8
Money and Credit (annual percent change) 2/ 5/						
Reserve money	-19.3	19.4	23.7	30.9	7.2	12.0
Broad money	7.8	12.9	24.1	21.0	8.1	11.1
Bank credit to the economy	27.6	-5.2	5.4	10.1	27.9	13.8
Interest rates (end of period) 2/						
On three-month deposits	16	17	10-15	9-11	...	...
On short term loans	12-18	12-20	22-25	16	...	...
Balance of payments (in millions of U.S. dollars)						
Exports	362	370	450	500	659	749
Imports	650	633	694	977	1142	1239
Current account balance (including official transfers)	-146	-131	-174	-361	-464	-394
(in percent of GDP)	-8.3	-7.2	-8.1	-14.4	-16.4	-12.7
Gross official reserves (in millions of U.S. dollars)	134	196	214	227	229	250
(in months of prospective goods and services imports) 6/	2.4	3.0	3.7	3.4	3.0	3.0
(in percent of short-term debt)	352	419	305	274	156	168
External public debt 7/						
(in millions of U.S. dollars)	1,600	1,717	1,915	2,086	2,225	2,416
(in percent of GDP)	91	94	90	83	79	78
Net present value (in percent of exports)	...	...	205	199	171	166
External public debt service						
(in millions of U.S. dollars)	36	36	40	52	67	73
(in percent of exports)	6.8	6.7	6.7	7.5	7.8	7.6
(in percent of revenue, excluding grants)	15.5	15.3	17.3	18.7	21.7	20.2
Exchange rate						
Commercial bank rate (kip per dollar; end of period)	9,490	10,680	10,467	10,377	...	...
Nominal effective exchange rate 8/	95.7	83.3	73.1	71.2	...	...
Real effective exchange rate 8/	102.1	97.3	97.6	103.2	...	...
Memorandum item:						
Nominal GDP (in billions of Kip)	15,702	18,401	22,598	26,540	30,237	34,216

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

1/ Projected.
2/ Fiscal year basis (October to September).
3/ Numbers for 2005 are estimates and for 2006 are staff proposal.
4/ Royalties and taxes from timber, mining and hydro-power projects.
5/ Money and credit data are evaluated at current exchange rates.
6/ Excludes imports associated with NT2 and the large Oxiana and Pan Australian mining projects.
7/ Russian debt is based on a preliminary agreement between the Lao P.D.R. and Russian governments.
8/ Base Year 2000=100.

Table 2. Lao P.D.R.: Balance of Payments, 2003–2010

	2003	2004	2005	2006	2007	2008	2009	2010
		Est.	Projections					
	(In millions of U.S. dollars, unless specified otherwise)							
Current Account	-174	-361	-464	-394	-494	-354	-312	-188
Excluding official transfers	-237	-420	-530	-475	-578	-440	-399	-284
Merchandise trade balance	-244	-478	-483	-490	-582	-421	-417	-264
Exports, f.o.b.	450	500	659	749	782	918	938	1117
of which large projects 1/	60	58	216	306	346	461	465	629
Imports, c.i.f.	694	977	1142	1239	1364	1339	1355	1381
of which large projects 1/	45	232	292	319	390	305	251	202
Services (net)	95	132	141	152	163	175	189	203
of which tourism	84	119	133	145	157	170	184	199
Income (net)	-113	-101	-215	-166	-192	-230	-209	-264
Interest payments	-38	-54	-106	-102	-117	-120	-97	-117
of which public	-15	-27	-31	-33	-34	-36	-38	-39
Dividends and profit repatriation	-78	-59	-125	-93	-110	-151	-158	-197
of which large projects 1/	-34	-7	-72	-40	-46	-77	-75	-103
Other	3	12	16	29	35	40	45	50
Transfers (net)	87	85	93	111	116	121	125	137
Private	24	26	28	30	33	35	38	41
Official	63	60	66	81	83	86	87	95
Capital Account	196	379	470	418	520	381	340	217
Public sector	118	118	150	192	152	120	104	97
Disbursements	146	147	191	238	202	187	177	173
Amortization	-28	-29	-41	-46	-50	-67	-73	-76
Banking sector (net)	-21	-39	47	-14	-15	-16	-17	-18
Private sector	100	300	274	240	382	277	253	138
Foreign direct investment (net)	42	256	265	205	327	222	151	21
of which large projects 1/	30	200	272	212	281	168	88	-59
Other private flows and errors and omissions	58	45	9	35	56	55	101	117
Overall Balance	22	18	7	24	25	26	28	29
Financing	-22	-18	-7	-24	-25	-26	-28	-29
Central bank net foreign assets	-22	-18	-7	-24	-25	-26	-28	-29
Assets (increase -)	-18	-12	-2	-12	-63	-55	-55	-16
Liabilities (reduction -)	-4	-6	-5	-12	37	28	27	-13
Memorandum Items:								
Current account (percent of GDP)	-8	-14	-16	-13	-15	-10	-8	-4
(excluding official transfers)	-11	-17	-19	-15	-17	-12	-10	-7
Official gross reserves (in millions of USD)	214	227	229	250	275	302	329	359
(in months of imports, excl. large projects 1/)	3.7	3.4	3.0	3.0	3.2	3.3	3.4	3.4
Nominal GDP at market prices (in millions of USD)	2,138	2,501	2,828	3,104	3,358	3,651	3,941	4,323

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

1/ Nam Theun 2 hydroelectric dam and large mining projects.

Table 3. Lao P.D.R.: Summary of General Government Operations, 2002/03–2005/06

	2002/03	2003/04	2004/05		2005/06	
			Rev. Budget	Staff	Budget Plan	Staff
			(In billions of kip)			
Revenue and grants	2,794	3,103	3,875	3,623	5,316	4,353
Revenue	2,341	2,821	3,337	3,200	3,956	3,868
Tax	1,924	2,328	2,763	2,654	3,336	3,254
of which: mining royalties and taxes	...	...	...	48	...	242
Nontax	417	493	574	546	620	614
Grants	453	283	538	423	1,360	485
Expenditure	4,017	3,967	5,126	4,661	6,716	5,670
Current	1,527	1,890	2,479	2,385	2,949	3,039
Wage bill	840	1,076	1,401	1,329	1,740	1,650
Wages, salaries and benefits	668	833	1,080	1,043	1,310	1,277
Compensations and allowances	172	243	321	287	430	373
Subsidies and transfers	169	124	202	200	280	280
Interest payments	123	235	306	270	353	345
of which: external	115	194	256	247	281	268
Other recurrent	394	456	570	585	576	764
Capital and onlending	2,370	1,853	2,647	1,900	3,512	2,376
Domestically financed 1/	1,026	799	543	580	425	667
Externally financed	1,499	1,169	2,227	1,450	3,225	1,829
Onlending (net)	-156	-115	-123	-130	-138	-119
Debt repayment/Contingency	120	224	0	377	255	255
Overall balance	-1,222	-864	-1,251	-1,039	-1,400	-1,317
Financing	1,222	864	1,251	1,039	1,400	1,317
Domestic financing (net)	97	-59	-205	57	-82	0
Bank financing 2/	92	-66	-212	51	-88	0
Nonbank financing	5	6	7	6	6	0
Foreign financing (net) 3/ 4/	1,108	923	1,460	982	1,482	1,318
Disbursements	1,309	1,151	1,769	1,233	1,910	1,694
Amortization	-201	-228	-309	-251	-428	-376
Discrepancy/Financing gap	18	0	-4	0	0	0
			(In percent of GDP)			
Revenue and grants	13.0	12.1	13.2	12.4	16.0	13.1
Revenue	10.9	11.0	11.4	10.9	11.9	11.6
Tax	8.9	9.1	9.4	9.1	10.0	9.8
Nontax	1.9	1.9	2.0	1.9	1.9	1.8
Grants	2.1	1.1	1.8	1.4	4.1	1.5
Expenditure	18.6	15.5	17.5	15.9	20.2	17.1
Current	7.1	7.4	8.5	8.1	8.9	9.1
Wage bill	3.9	4.2	4.8	4.5	5.2	5.0
Wages, salaries and benefits	3.1	3.3	3.7	3.6	3.9	3.8
Compensations and allowances	0.8	1.0	1.1	1.0	1.3	1.1
Subsidies and transfers	0.8	0.5	0.7	0.7	0.8	0.8
Interest payments	0.6	0.9	1.0	0.9	1.1	1.0
of which: external	0.5	0.8	0.9	0.8	0.8	0.8
Other recurrent	1.8	1.8	1.9	2.0	1.7	2.3
Capital and onlending	11.0	7.3	9.0	6.5	10.6	7.2
Domestically financed 1/	4.8	3.1	1.9	2.0	1.3	2.0
Externally financed	7.0	4.6	7.6	4.9	9.7	5.5
Onlending (net)	-0.7	-0.5	-0.4	-0.4	-0.4	-0.4
Debt repayment/Contingency	0.6	0.9	0.0	1.3	0.8	0.8
Overall balance	-5.7	-3.4	-4.3	-3.5	-4.2	-4.0
Financing	5.7	3.4	4.3	3.5	4.2	4.0
Domestic financing (net)	0.4	-0.2	-0.7	0.2	-0.2	0.0
Foreign financing (net) 3/ 4/	5.1	3.6	5.0	3.3	4.5	4.0
Discrepancy/Financing gap	0.1	0.0	0.0	0.0	0.0	0.0
Memorandum items:						
Domestic expenditure (percent of GDP)	11.7	10.9	9.9	11.0	10.5	11.6
of which: non-wage 5/	7.8	6.7	5.1	6.4	5.3	6.6
GDP (in billions of kip)	21,549	25,555	29,313	29,313	33,222	33,222
Bank restructuring bonds 6/	139	108	254	...	200	200
Exchange rate (Kip per U.S. dollar)	10,636	10,594	10,604	10,604	10,942	10,942
Program aid (in mn USD)	...	25	7.5	19.4	4.1	32.0

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

1/ In 2003/04 includes discrepancy.
2/ Excludes bank restructuring bonds.
3/ In 2001/02 includes a transfer of $33 million from EDL to the government from the Theun-Hinboun Power Company refinancing.
4/ Foreign financing does not include loans for government equity contribution to the NT2 project.
5/ Excludes donor financed capital expenditure.
6/ In 2002/03 and 2003/04 the bonds were Debt Clearance Bonds issued to state banks to settle budget obligations to contractors with NPLs.
In 2004/05 includes bank recapitalization bonds.

Table 4. Lao P.D.R.: Monetary Survey, 2003–2006 1/

(In billions of kip, unless otherwise indicated)

	2003	2004				2005				2006		
	Dec	Mar	Jun	Sept	Dec	Mar	Jun 2/	Sept	Dec	Mar	Jun	Sept
									Proj.	Proj.		
Bank of Lao (BoL)												
Net Foreign Assets	1,835	1,809	2,017	1,957	2,031	2,022	2,123	2,031	2,111	2,110	2,142	2,225
(In millions of US dollars)	173	171	190	185	192	191	200	192	199	199	202	210
Net Domestic Assets	-456	-365	-581	-420	-475	-360	-452	-379	-390	-350	-342	-386
Government (net)	-379	-363	-550	-352	-456	-307	-397	-346	-391	-351	-343	-387
Kip	-25	-64	-93	-33	-98	-65	-55	11	-30	-30	-30	-30
Foreign currency	-354	-299	-457	-320	-358	-242	-342	-357	-361	-321	-313	-357
Economy	685	722	717	709	738	723	382	368	361	361	361	361
Banks	138	139	134	138	131	128	128	145	190	190	190	190
BoL securities	-46	-38	0	0	0	0	0	0	0	0	0	0
Other items (net)	-854	-825	-882	-915	-889	-904	-565	-546	-550	-550	-550	-550
Reserve money	1,379	1,445	1,436	1,537	1,556	1,662	1,672	1,652	1,722	1,760	1,799	1,840
Currency in circulation	262	306	316	350	511	578	579	613	712	730	748	767
Bank reserves (Kip)	319	299	283	359	213	258	263	262	223	229	235	241
Bank reserves (Forex)	798	839	837	828	832	826	830	777	786	801	817	833
Monetary Survey												
Net foreign assets	2,773	3,042	3,287	3,065	3,381	3,493	3,299	2,958	2,959	3,011	3,075	3,179
(In millions of US dollars)	262	287	310	289	319	330	311	279	279	284	290	300
Net domestic assets	1,400	1,526	1,323	1,678	1,688	1,824	1,801	2,175	2,287	2,366	2,437	2,470
Government (net)	-136	-173	-371	-152	-215	-115	-205	-101	-131	-101	-151	99
Budget	-346	-383	-581	-398	-462	-361	-451	-347	-377	-347	-397	-347
Other	210	210	210	246	246	246	246	246	246	246	246	446
Credit to the economy	2,480	2,603	2,559	2,625	2,705	2,870	2,675	2,951	3,143	3,192	3,313	3,096
Other items (net)	-944	-903	-866	-795	-802	-931	-669	-675	-725	-725	-725	-725
Broad Money	4,173	4,568	4,610	4,743	5,068	5,317	5,099	5,133	5,246	5,378	5,512	5,650
Currency outside banks	262	306	316	350	511	578	579	613	712	730	748	767
Kip deposits 3/	1,244	1,392	1,363	1,428	1,435	1,535	1,455	1,456	1,439	1,475	1,512	1,550
Foreign currency deposits	2,667	2,870	2,931	2,964	3,122	3,204	3,066	3,065	3,095	3,173	3,252	3,334
	(Annual percentage change)											
Reserve money (at current exchange rates)	28.5	28.4	16.7	30.9	12.9	15.3	16.7	7.2	12.0	8.0	8.5	12.0
Kip reserve money	92.2	76.9	37.7	49.3	24.6	38.0	40.6	23.4	29.2	14.7	16.8	15.1
Broad money (at current exchange rates)	15.5	18.3	19.8	21.0	21.5	16.6	11.1	8.1	5.5	4.4	9.6	11.1
Kip broad money	37.8	35.6	34.7	29.3	29.2	24.5	21.2	16.3	10.5	4.3	11.1	12.0
Money multiplier (at current exchange rates)	3.0	3.2	3.2	3.1	3.3	3.2	3.1	3.1	3.1	3.1	3.1	3.1
Credit to the economy (at current exchange rates) 4/	1.1	3.3	10.5	10.1	10.7	12.0	22.5	27.9	35.9	31.6	26.3	13.8
State bank credit to the economy (at current exchange rates) 4/	-6.5	-3.0	8.0	20.6	13.1	28.3	39.5	34.5	61.0	43.2	32.4	43.9
Memorandum items:												
Gross official reserves (in millions of US Dollars)	214	210	228	220	226	224	231	223	229	229	232	240
Net international reserves (in millions of US Dollars) 5/	98	92	111	107	113	113	122	118	125	124	125	131
Disbursement of Program Loans 6/	12	12	24	24	24	24	24	34	44	44	49	59
Issue of Debt Clearance/Bank Recapitalization Bonds 7/	210	210	210	246	246	246	246	246	246	246	246	446
Program Exchange Rate (kip per US dollar)	10,600	10,600	10,600	10,600	10,600	10,600	10,600	10,600	10,600	10,600	10,600	10,600
Actual Exchange Rate (kip per US dollar)	10,470	10,381	10,649	10,850	10,465	10,400	10,735	10,843	...	...	...	...

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

1/ All figures evaluated at program exchange rate, unless otherwise indicated.
2/ Includes debt write-offs by the BoL on NPLs to SOEs (amounting to Kip 320 billion), reflected in a decrease in credit to the economy and a corresponding adjustment in provisioning under other items (net).
3/ Includes BoL securities held outside of the banking system.
4/ Adjusted for the impact of debt write-offs and Debt Clearance/Bank Recapitalization Bonds.
5/ Net Foreign Assets of BoL minus foreign currency component of reserve money.
6/ In millions of U.S. dollars, cumulative since March 2003.
7/ Cumulative since end-June 2003.

Lao P.D.R.—Fund Relations
(As of December 31, 2005)

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

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

III. **SDR Department:**	**SDR million**	**Percent Allocation**
Net cumulative allocation	9.41	100.00
Holdings	9.86	104.75

IV. **Outstanding Purchases and Loans:**	**SDR million**	**Percent Quota**
ESAF/PRGF arrangements	20.47	38.69

V. **Latest Financial Arrangements:**

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

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

	Forthcoming				
	2006	**2007**	**2008**	**2009**	**2010**
Principal	2.21	1.95	2.72	3.62	3.62
Charges/interest	0.10	0.09	0.08	0.06	0.04
Total	2.31	2.03	2.79	3.68	3.66

VII. Implementation of HIPC Initiative

Lao P.D.R. is eligible for assistance under the HIPC Initiative. However, to date the authorities have indicated that they do not want to avail themselves of this facility.

VIII. Safeguards Assessments

A safeguards assessment of the Bank of Lao P.D.R. (BoL) was completed in April 2003 with respect to the PRGF arrangement approved in 2001. The main findings, recommendations, and progress thereon, were reported in IMF Country Report No. 03/308 and IMF Country Report No. 05/8. Progress on safeguards recommendations has been slow. The authorities have indicated that they are not in a position to implement an earlier agreement to undertake a joint-audit of the BoL's 2003 and 2004 accounts by the state auditor and an international audit firm.

IX. Exchange Rate

In September 1995, Lao P.D.R. adopted a managed floating exchange rate system. From October 1997, commercial banks have been encouraged to follow the parallel market closely. From October 27, 2003, the commercial bank exchange rate is calculated by the BoL as the weighted average of the previous day's commercial banks' and interbank market rates. The BoL provides this reference rate to the commercial banks, who then set their own rates, keeping them close to the parallel market rates. On January 30, 2006 the commercial bank exchange rate was kip 10,450 (buying) and kip 10,540 (selling) per U.S. dollar.

X. Exchange and Payments System

Lao P.D.R. no longer maintains restrictions on the making of payments and transfers for current international transactions under the transitional arrangements of Article XIV, Section 2, but maintains restrictions imposed solely for the preservation of national or international security, which have been notified pursuant to Decision No. 144-(52/51), and a restriction subject to Fund approval under Article VIII (tax payment certificates are required for some transactions). A joint LEG/MFD mission in August 2004 conducted a review of the exchange system to establish the remaining measures that would facilitate Lao P.D.R.'s acceptance of the obligations under Article VIII, including the elimination of an exchange restriction on the making of payments and transfers for current international transactions.

XI. Last Article IV Consultation Discussions

The last Article IV consultation discussions were held in Vientiane during July 21–August 4, 2004. The staff report (IMF Country Report No. 05/8) was discussed by the Executive Board on November 29, 2004.

XII. Resident Representative

Mr. Philippe Beaugrand assumed the post of resident representative in Vientiane on January 28, 2004.

XIII. **Technical Assistance (since 2002)**

Department		Purpose	Date
STA	-	Government finance statistics.	4–5/04
	-	Money and banking statistics.	4–5/04
	-	Multisector statistics/GDDS mission.	10/02
FAD	-	Missions on tax policy and administration.	3/02, 10/04
	-	Expert on tax administration.	3–4/03, 11/03, 3–4/04, 11/04
	-	Expert on customs administration.	3–4/03, 7–8/03, 11/03, 1/04, 6/04, 2/05
	-	Mission on public expenditure management.	10/02, 6–7/04, 10/04
	-	Expert on public expenditure management.	11/04, 3–4/05
MFD	-	Expert on banking supervision.	4–5/02, 7/02, 10-11/02, 1/03, 6–4/03, 7/03, 10-12/03, 1–2/04, 5–7/04, 9-10/04, 1–3/05, 4–6/05, 9-12/05
	-	Mission on Central Bank audit.	5/05
	-	Expert on foreign exchange regulations.	7–8/04

Lao P.D.R.: Fund-Bank Relations Annex[29]

Partnership for Development

The Government (GOL) of the Lao Peoples' Democratic Republic (P.D.R.) aims to achieve rapid economic growth in order to improve the living conditions of its poor and graduate from its status as a least-developed country. The World Bank Group—International Development Association (IDA), International Finance Corporation (IFC), Mekong Private Sector Development Facility (MPDF), World Bank Institute (WBI) and the Multilateral Investment Guarantee Agency (MIGA)—provides technical and financial support to Lao P.D.R. in the implementation of this strategy.

IMF-World Bank Collaboration in Specific Areas

The IMF takes the lead in advising the GOL on macroeconomic policy. This support covers tax, fiscal, monetary, interest rate and exchange rate policies, balance of payments and related statistical issues. In addition, some aspects of four structural policy areas that have an important bearing on macroeconomic performance (financial sector, revenue administration, public expenditure management, and trade policy) are also integral to the Fund's work program. The Bank has taken the lead in supporting the GOL in growth strategies, poverty analysis and advice, poverty and social impact assessments, consultations for the poverty reduction strategy, SOE reform and restructuring, and legal/judicial development, in addition to natural resource management and sectoral reforms. The Bank in coordination with the Fund advises the GOL on structural areas of the financial sector, public expenditure management and trade policy as well as in supporting the GOL in the implementation of its poverty reduction strategy (NGPES). Both institutions also collaborate closely with the AsDB on financial sector reform and public expenditure management, and with the UN agencies in the trade policy and the NGPES implementation and costing.

Bank and Fund Policy Dialogue

Poverty Reduction Strategy. The Bank and the Fund, together with UNDP, have provided assistance to the GOL's process of formulating its medium-term poverty reduction strategy. In April 2001, the GOL submitted an I-PRSP to the Boards of the World Bank and the IMF, and Progress Reports on the preparation of the full PRSP were submitted in August 2002 and September 2003. In May 2003, the GOL circulated the first draft of the full PRSP, which was initially called the *National Poverty Eradication Program* (NPEP). The final text takes the name of *National Growth and Poverty Eradication Strategy* (NGPES), and is based on the five-year National Socio-Economic Development Plan for 2001–05 (NSEDP). The Bank and

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[29] Prepared by the staff of the World Bank. Contact person: Mr. Alessandro Magnoli, Senior Economist, Poverty Reduction and Economic Management Department, East Asia and Pacific Region, email: amagnoli@worldbank.org.

the Fund's Joint Staff Advisory Note (JSAN) of the strategy has been prepared in October 2004, and was considered by the IDA and IMF Boards in November 2004.

Public Expenditure Management. In 2002, the Bank completed a Public Expenditure, Financial Management and Procurement Review (PER), jointly with the IMF, the AsDB and the GOL. These assessments provided a further basis for the GOL's reform program that has been supported by the IMF's PRGF and by the Bank's financial support in the form of the Financial Management Adjustment Credit (FMAC),[30] and the technical assistance provided by the Financial Management Capacity Building Credit (FMCBC), the IDF grants to improve public financial management, the efficiency of the procurement regime, and tariff-studies.

Over the medium term, the Bank expects to further support public financial management reforms through a number of Poverty Reduction Support Operations (PRSOs). The PRSOs, adjustment operations supporting the implementation of the NGPES, will assist the GOL's reform efforts, inter alia, in the areas of public sector governance, social sectors, trade, and private sector development (PSD). PRSO-1 was considered by the IDA and IMF Boards in March 2005, and supported critical public sector reforms targeted to (a) public resource management; (b) public expenditure policies; and (c) sustained growth.[31] The GOL has agreed to the implementation of the Public Expenditure Management Strengthening Program (PEMSP) and of a rolling program of PERs, public expenditure tracking surveys (PETS) and analytical work geared to monitoring progress in the implementation of PEMSP and assessing the compliance environment and the impact of public spending in key sectors. The 2005 PER is a key element of this program, and its findings will facilitate both (i) the update of the PEMSP action plan; and (ii) the effective use of public resources from NT2 and other natural resource projects.

Financial Sector Reforms. The World Bank and the IMF have worked closely with the AsDB to support the Bank of Lao P.D.R. (BoL) in developing and implementing a multi-year banking reform program, with technical assistance provided by the AsDB. The Bank's FMAC and PRSO-1 supported restructuring of state-owned commercial banks (SCBs) and their move to a more commercial basis of operation, as well as the development of rural micro-finance institutions. The FMAC, supported by the FMCBC, the PRGF and PRSO-1 have sought to break the NPL destabilizing cycle as a key step in the process of better management of public resources and fiscal stability. It is expected that this support will

[30] This was a two-tranche adjustment operation of US$17 million, with the first tranche of US$7 million disbursed in January 2003. The second-tranche was disbursed in May 2004.

[31] PRSO-1 was disbursed in September 2005, for the amount of US$ 10 million: a credit of SDR3.0 million (US$ 4.5 million equivalent) and a grant of SDR3.6 million (US$ 5.5 million equivalent). The terms for the Credit are standard IDA terms: 40-year maturity with a 10-year grace period. For the Grant, standard IDA grant terms.

be needed over the medium term, which could be provided by follow-on PRSOs and the programs of the IMF and the AsDB.

Trade Policy. Trade policy was an integral part of both the Bank and IMF's earlier analytical work and programs. The WBI conducted several seminars on trade policy issues, and in April 2004, organized a face-to-face workshop on WTO accession and its potential for exports and poverty reduction. The Bank completed the updating of earlier work on Lao P.D.R.'s trade regime and exports, and is leading a larger piece of diagnostic work on trade policy and export potential during June–October 2004; this is being done jointly with the GOL (led by the Ministry of Commerce) under the Integrated Framework program. Reforms in this area are were supported by PRSO-1 and will be supported by follow-on PRSOs.

The Bank's Key Roles in Policy Dialogue

State-Owned Enterprises (SOEs). The SOEs have been large users of resources and certainly have been the main debtors to SCBs; they have also been major contributor to the problem of NPLs at SCBs. Accordingly, the FMAC and PRSO-1 supported the GOL's ongoing SOE reform program aimed at improving and institutionalizing the reporting and recording of annual performance of all SOEs, the restructuring of the nine large SOEs including, BPKP, Pharmaceutical Factory No. 3, Nam Papa Lao, Lao Airlines, DAFI, *Electricité du Lao*, and DAI SOEs, and appropriate pricing policy for public utility SOEs. The Bank will support the implementation of the SOE's multi-year restructuring plans, the monitoring system as well as the utilities' tariff-policies beyond FMAC and PRSO-1; this will be done through follow-on PRSOs, the technical assistance grants and credits, and analytical work.

Private Sector Development. The Bank supports the development of the private sector, both economy-wide and in sectors. Over the next 12 months the World Bank Group (IDA, IFC, MPDF) will carry out extensive analysis in the PSD area to define a prioritized and feasible multi-year Action Plan with the objective of removing the constraints to private sector growth. Specific activities under this initiative include a joint ADB-WBG Investment Climate Survey of manufacturing and tourism firms in Lao P.D.R., provincial level reviews of the regulatory procedures and PSD promotion initiatives of local governments; a review of the key business laws, and coordination of the donor working group on macroeconomic and PSD issues.

Forestry Development. The GOL is involved in a continuing process of reforming its forestry sector and improving the implementation of forestry programs and projects. The Bank is trying to ensure that the GOL's objectives and strategy for forestry are nested within and consistent with the overall NGPES/PRSP, Rural Development Program, and Agriculture Development Strategy. Through these, the GOL is, inter alia, seeking to (i) stabilize or increase forest cover and condition; (ii) ensure protection of water resources and critical infrastructure through forest conservation; and (iii) put forest resources to work directly for the reduction of rural poverty through partnerships with local communities.

The Nam Theun 2 Hydro-power Project. The World Bank Group's has supported this project through an IBRD partial risk guarantee, an IDA environmental and social project and a MIGA guarantee. The World Bank decision to support the project was linked to (i) Lao P.D.R. establishing and implementing a viable development policy framework, characterized by concrete performance, and national programs for poverty reduction and social and environmental protection; (ii) the technical, financial, economic and implementation aspects of the project, as well as the design and implementation of safeguards policies, being sound; and (iii) wider understanding and broader support from the international donor community and global and local civil society for Lao P.D.R.'s development framework and the project.

World Bank Strategy and Lending Operations

Country Assistance Strategy (CAS). The last CAS was presented to the Bank's Board in March 2005; this timing was aimed at using the NGPES as the basis for the CAS. The CAS selectively targets key NGPES priorities, including: (i) sustaining growth through linking to and capitalizing on regional opportunities and better natural resource management; (ii) improving social outcomes through strengthening financial management and service delivery capacity; (iii) strengthening management capacities, partnerships, and monitoring for NGPES implementation, and (iv) implementing the NT2 program as a model for supporting sustainable growth, improving social outcomes, and building key development capacities. This consists of a lending and non-lending program, with a notional program of about US$128 million in new commitments (credits and grants) for the four years of the CAS during July 1, 2005 to June 30, 2008 (subject to the IDA Performance Based Allocation system).

Non-Lending Program. The current sources of growth in the Lao P.D.R. economy have been examined in a Country Economic Memorandum/Sources of Growth report, which was completed in May 2004 and shared with the GOL.

The World Bank's Main Non-Lending Work
(recently completed and ongoing)

Area	Instrument
Poverty Reduction	Poverty Report (completed, 2002) Poverty Assessment (FY06) Khammouane Provincial Development Study (FY06) Poverty-Environment Nexus Study Phase 1 (completed, 2002);
Growth Analysis	Sources of Growth - CEM (completed, May 2004)
Public Expenditure Management	PER, CFA, CPAR (completed, 2002); Public Expenditure Tracking in Health & Education (FY06)(FY06) Integrated PER with CFAA/CPAR (FY06)
Private Sector Development & Trade Policy	Financial Sector Strategy (completed FY05)Private Sector Assessment/Investment Climate Assessment (FY06) Integrated Trade Framework (FY06)
Capacity Enhancement & Public Sector Reform	Note on Capacity Enhancement for CAS (June 2004) Civil Service Reform for Teachers (FY06) Education Sector Study (FY06)

Lending Operations

As of September 30, 2005, IDA credits and grants totaling US$813.9 million equivalent had been approved for Lao P.D.R. including support for adjustment operations, rural development, forestry, transport, energy, telecommunications, education, health, industry, capacity building, and risk guarantees. In the last three years, IDA support has focused on the CAS objectives, with an average commitment of about US$31 million (excluding guarantees), while disbursements averaged US$41 million. Future IDA credits/grants will finance projects in the social sectors, infrastructure, public financial management, rural livelihoods, capacity building, and reforms in support of poverty reduction.

IDA: Commitments and Disbursements to Lao P.D.R., 1977–2005
(In millions of U.S. dollars; as of September 30, 2005)

Fiscal Year (to June 30)	Committed	Disbursed	Repayments
1977-93	335.2	180.7	1.5
1994	48.4	45.1	0.6
1995	19.2	31.4	0.6
1996	60.7	28.6	0.6
1997	48.0	65.2	0.6
1998	34.7	26.5	1.3
1999	29.8	27.8	1.5
2000	0.0	18.1	3.0
2001	41.7	29.9	3.6
2002	44.8	30.5	4.9
2003	24.7	41.2	6.1
2004	35.7	46.7	7.3
2005	76.0	36.0	8.4
2006 (to 9/30/05)	15.0	16.6	3.6
Total	813.9	624.5	43.6

Lao P.D.R.—Relations with the Asian Development Bank[32]

The Asian Development Bank (AsDB) has extended development assistance to Lao P.D.R. since 1968. In the 1970s and 1980s, AsDB assistance was focused mainly on economic growth projects involving infrastructure development in the transport and energy sectors, as well as agriculture. AsDB has been active in financial sector development since the latter part of the 1980s. Since the early 1990s, the emphasis of AsDB assistance to Lao P.D.R. has been broadened to include rural development, social development and environment. Since the late 1990s, the AsDB has focused its activities on poverty reduction.

AsDB worked with the Government and other stakeholders to formulate its current Country Strategy and Program in 2001 to guide its operations in Lao P.D.R. for the next five-year period. The theme of AsDB's interventions in Lao P.D.R. will be poverty reduction by broadening community participation and opportunities. The core strategies for poverty reduction are: sustainable economic growth, inclusive social development, and good governance. The main strategic focus will be on four operational priorities including rural development and market linkages, human resource development, sustainable environmental management, financial and private sector development, and regional integration.

Lao P.D.R. is a key actor in the Greater Mekong Sub-Region (GMS) program as a land-link among the other member countries. The AsDB will aim to explore various options to maximize the benefits to Lao P.D.R. from sub-regional cooperation. To enhance the development impact of projects and ensure their close monitoring, AsDB's interventions will focus primarily on the poor northern region provinces and along the East-West economic corridor, which links Thailand to Savannakhet and Vietnam.

Since 1970, the AsDB has approved 62 loans (including four loans for the financial/banking sector reforms) for a total of $1,113.1 million by end-December 2004, when 23 of these loans were still active. As of end-December 2004 technical assistance amounting to $101.9 million comprising 208 projects has been approved.

In 2005, four new lending products (including a loan and a grant for the public sector, and a private sector investment facility and guarantee) have been approved by end-August, and three additional loans and grants are envisaged to be approved, with the planned annual commitments of $156.0 million. Technical assistance of $1.82 million was approved during the first eight months of 2005.

Table 1. Lao P.D.R.: AsDB Commitments and Disbursements, 2000–2006

(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005 1/	2006 1/
Commitments	60.5	65	86.9	46	27.7	156.0	22.8
Disbursements	51	44.7	45.6	54.7	48.5	76.4 2/	t.b.d.

Source: Data provided by the Asian Development Bank.

1/ Planned figures.
2/ Public sector disbursements only.

[32] Prepared by the Asian Development Bank.

Lao P.D.R.: Statistical Issues

The quality of macroeconomic statistics needs to be significantly improved for effective monitoring of economic developments and policy formulation. In this regard, a multisector STA mission visited Vientiane during October 2002 to facilitate the preparation of the General Data Dissemination System (GDDS) metadata. It recommended greater coordination between the various agencies responsible for compiling macroeconomic statistics, including the formation of an inter-agency working group. While a GDDS coordinator has been appointed, the authorities have yet to finalize the GDDS metadata and a strategy for statistical improvement. Two STA missions took place in April/May 2004 in the areas of government finance statistics and monetary and financial statistics. Economic and financial data are published in periodic reports by the National Statistical Center (NSC) and the Bank of Lao P.D.R. (BoL).

National accounts

National accounts consist of annual estimates of GDP by activity at current and constant 1990 prices, broadly following the *System of National Accounts 1968 (1968 SNA)*. The lack of regular surveys to collect comprehensive data on current economic activities and the use of inadequate compilation methods raise questions about the coverage and reliability of the GDP estimates. The estimates rely heavily on data on production or volume indicators collected by line ministries. The October 2002 multisector STA mission recommended that the authorities establish a system for collecting data on current economic activities based on regular surveys and implement compilation methods in accordance with the *System of National Accounts 1993 (1993 SNA)*. The Swedish International Development Agency (SIDA) is providing technical assistance to the NSC to improve the national income accounts. With SIDA support, the Lao Expenditure and Consumption Survey 2002–2003 (LECS 3) has been finalized and released. A STA regional advisor will assist the authorities in improving the real sector indicators during visits scheduled for 2006.

Prices

The NSC compiles a monthly CPI that is available on a timely basis. The latest CPI was introduced in January 2000 (with December 1999 as the reference period), using the results of the 1997/98 Lao Expenditure and Consumption Survey (LECS) for deriving a consumption basket. It comprises nine product categories covering major urban centers, including Vientiane. The NSC plans to revise the weights and review the sample of outlets and products on the basis of the LECS 3. With SIDA's assistance, the NSC is also working on the development of a producer price index (PPI) on a quarterly basis.

Government finance

Government finance statistics are weak and there is scope to significantly improve their accuracy, coverage, and transparency. The Budget Department produces monthly, quarterly, and annual revenue and expenditure statistics. Most data are recorded on a cash basis. Expenditure data by economic type are compiled by central government and the provinces. Data on bank and nonbank financing of the budget, including treasury bill operations, need to be made consistent with the monetary accounts. The social security fund and off-budget activities are not included in fiscal data. Annual budget and outturn data are not disseminated according to an international standard, which complicates fiscal analysis. A government finance statistics mission in 2004 recommended improving the quality of fiscal statistics and developed a roadmap for eventual migration to *GFSM2001*.

Budget planning, execution, reporting, and cash management require significant upgrading, as noted by the October 2002 FAD mission on public expenditure management. Moreover, greater decentralization in 2000/01 further complicated the timely reporting of fiscal data from lower government levels, as monitoring systems are weak and skilled staff limited. This continues to hamper the accurate reporting of various items to the central budget, such as timber-related royalty payments.

Central government debt data are compiled by two departments of the MOF; external debt by the External Financial Relations Department and domestic debt by the Budget Department. Debt data are comprehensive and available by type of debt holder and instrument. Efforts are being made to further improve coverage, particularly relating to SOE debt.

Monetary statistics

The BoL regularly reports its balance sheet (with a two-week lag) and commercial bank balance sheet (with a four-week lag) to APD for surveillance purposes and to STA for publication in *IFS* with a lag of two to three months. In recent years, the authorities have been implementing some of the recommendations of STA missions.

However, the latest monetary and financial statistics mission in April/May 2004 identified a number of problems in the compilation of monetary statistics and made further recommendations for (i) improvement in the sectorization of various institutional units (e.g., nonfinancial public enterprises) and uniform treatment of sectors on both asset and liability sides of the commercial bank balance sheet; (ii) valuation of financial assets and liabilities (e.g., valuing monetary gold at market prices); (iii) classification of financial instruments (e.g., classifying loan loss provisions as other liabilities and valuation adjustments as part of shares and other equity); (iv) improvement in the chart of accounts for BoL and commercial banks, including preparation of a "Manual of the Chart of Accounts"; (v) improvements in the coverage and identification of IMF accounts; (vi) reconciliation of differences between the accounting data (from the Accounting Department of the BoL) with monetary data sent to APD and STA (compiled by the Economic Research Department using source data from the Operations Department of the BoL); and (vii) on investigation of discrepancies in bank financing between monetary and government finance statistics. Many of the recommendations of the mission have yet to be implemented, including those to rectify the inconsistent sectorization of units on the asset and liability sides of the commercial bank balance sheet.

Balance of payments

Data on foreign reserves are reported weekly and derived from the monetary survey at the prevailing kip per U.S. dollar end-month exchange rate. Balance of payments statistics need significant frequency and coverage improvements in the following areas: (i) customs trade data, (ii) the commodity composition of external trade, (iii) services and income, (iv) actual foreign direct investment flows, (v) separation of current and capital transfers as well as coverage of some type of grants, especially from international nongovernment organizations, (vi) the reconciliation of fiscal and balance of payments data on external loans and grants, and (vii) monitoring of external debt, especially of state owned enterprises. In 2001, the MOF adopted the Commonwealth Secretariat-Debt Recording and Management System (CS-DRMS) for processing and maintaining external debt data.

New customs procedures (the Customs 2000 system) and equipment permitted (with FAD technical assistance) production of more accurate trade data in October 2000. However, for a range of technical reasons, the customs department has not yet produced these data on a regular basis. Fund missions have emphasized that this problem needs to be urgently addressed. In order to produce accurate balance of payments updates on a regular basis, there is a need to improve the coordination between the agencies involved in BOP compilation, viz., the BoL, the NSC, the Customs and the External Financial Relations Departments of the MOF, the Department of International Cooperation of the Committee of Planning and Investment, and the commercial banks. The Japanese Government is providing technical assistance to address some of these issues.

Lao P.D.R.: Table of Common Indicators Required for Surveillance
(as of February 6, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	01/31/06	01/31/06	D	D	O
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Dec 2005	01/17/06	M	M	O
Reserve/Base Money	Nov 2005	01/25/06	M	M	O
Broad Money	Nov 2005	01/25/06	M	M	O
Central Bank Balance Sheet	Nov 2005	01/25/06	M	M	O
Consolidated Balance Sheet of the Banking System	Nov 2005	01/25/06	M	M	O
Interest Rates[2]	Oct 2005	12/20/05	M	M	O
Consumer Price Index	Dec 2005	01/06/06	M	M	O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	FY 04/05	11/15/05	M	M	O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	FY 04/05	11/15/05	M	M	O
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Sept 2005	11/15/05	Q	Q	O
External Current Account Balance	Q3 2005	11/10/05	Q	Q	O
Exports and Imports of Goods and Services	Q3 2005	11/10/05	Q	Q	O
GDP/GNP	2004	06/24/05	A	A	O
Gross External Debt	Sept 2005	11/15/05	Q	Q	O

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA)

Lao P.D.R.: Analysis of Poverty Trends[33]

Lao P.D.R. is among the poorest countries in the world. Lao P.D.R.'s per capita gross national income is one of the lowest in East Asia, and three out of every four of its citizens survive on less than $2 a day. The incidence of poverty is higher in rural areas, and in the Northern and Central parts of the country.

There has been a notable decline in income poverty over the last decade. Based on the national poverty line, the incidence of poverty fell by more than a quarter in a decade—from 46 percent in 1992/93 to 39 percent in 1997/98 and 33.5 percent in 2002/03. This rate of reduction compares favorably to the experience of some other developing Asian economies during the 1990s. While the reduction in poverty has been impressive, Lao P.D.R. still has some way to go to catch up with its neighbors in the region.

Poverty Headcount Ratios ($1 a day)

	1990	2003
Lao PDR	**53**	**26**
Cambodia	29	19
China	32	12
Philippines	19	13
Thailand	13	2
Vietnam	51	11

The distribution of income has also remained relatively equal. At 33 percent, Lao P.D.R.'s Gini index implies a remarkably low level of inequality, partly reflecting the dominance of subsistence agriculture in the economy. While there was some deterioration during the early 1990s, the distribution of income has remained reasonably constant over the last decade as a whole. This casts a favorable light on the equity of the development process, although the extent to which it was the result of deliberate policy is unclear.

While there has been little rigorous analysis of the determinants of the decline in income poverty, a number of factors are likely to have contributed, including:

- *Robust economic growth.* Lao P.D.R. enjoyed sustained growth of around 6 percent for much of the last decade, with per capita income increasing at an annual rate of over 3 percent. The growth elasticity of poverty (the percentage change in poverty associated with a one percent increase in per capita income) is estimated to have increased from -1.3 during 1992–1997 to -3.8 during 1998–2003, implying that growth was markedly more pro-poor during the latter half of the decade (despite the hyperinflation during this period).
- *Infrastructure development.* There was an improvement in the state of infrastructure—including roads, electricity, and school and hospital buildings—in many poor rural areas,

[33] *Sources:* Engvall et al. (2005), Fane and Kong (2005), Kaspar et al. (2005), Warr (2005), and World Bank (2005).

particularly towards the second half of the decade. Indeed, studies suggest that as much as one-sixth of the reduction in rural poverty over this period can be explained by improved road access alone, and that rural poverty incidence could be further reduced by up to 7 percentage points by providing all rural districts with all-weather road access.

- *Trade liberalization.* Lao P.D.R. has made steady progress in integrating into the regional (and global) economy, especially after joining ASEAN and AFTA in 1998. Regional linkages have been reinforced by some major cross-border infrastructure projects (such as the East-West corridor linking Thailand and Lao P.D.R. to Vietnam). During the latter half of the decade, as trade relations with China and Vietnam were strengthened, poverty fell dramatically in the traditionally disadvantaged Northern districts bordering these countries. Further trade liberalization should result in continuing gains: a study by Fane and Kong (2005) suggests that poverty could be reduced by up to 1.5 percentage points between 2005 and 2009, simply on the basis of implementing AFTA commitments and extending them to all countries on an MFN basis.

However, progress has been more limited in several other dimensions of poverty. Notwithstanding the success against the target of halving income poverty relative to 1990, Lao P.D.R. lags behind on a number of Millennium Development Goals, in particular, those related to universal completion of primary education, maternal health, child malnutrition, and environmental sustainability (Table 1). More generally, it is ranked 133rd out of 175 countries on the basis of its human development indicators, most of which lag far behind those of other countries in the region. Indeed, some of these indicators are reminiscent of sub-Saharan Africa (Table 2). Average life expectancy is 15 years lower than in Vietnam, and below the average for low-income countries. The maternal mortality rate is more than five times as high as the average for the East Asia and Pacific region, and child malnutrition is higher than the average for low-income countries. Most indicators of educational attainment are also lower than in neighboring countries. One-third of the adult population—and nearly half of all females—cannot read or write, and the primary school enrollment rate is significantly lower than in Vietnam and Cambodia.

Inadequate public services have contributed, at least in part, to these poor social outcomes. Access to basic goods and services, such as education and health care, is severely limited. About half the children who enroll in primary school drop out, reflecting both the low quality and quantity of available schooling educational services. Although 85 percent of villages report having a primary school, only half of them offer all five grades. There are fewer than 100 doctors per 100,000 people, one of the lowest ratios in East Asia. Less than one-fifth of births are attended by skilled health staff, compared to around one-third in sub-Saharan Africa and 87 percent in East Asia and the Pacific. The immunization rate for children under 12 months (against major childhood illnesses such as measles and DPT) is below 50 percent, significantly lower than even in sub-Saharan Africa. More than half the population lives without access to an improved water source and more than three-quarters without access to improved sanitation, compared to 42 percent and 64 percent in sub-Saharan Africa, respectively. This backlog of deprivation presents a challenging agenda for the period ahead.

Table 1. Lao P.D.R.: Millennium Development Goals Indicators, 1990-2015

	1990	1995	1997	2001	2002	2003	Latest Data	2015 **Target**
1 Eradicate extreme poverty and hunger	2015 target = halve 1990 $1 a day poverty and malnutrition rates							
Population below $1 a day (%)	53.0	..	38.4	31.3	28.1	25.8	25.8 (2003)	[26.5]
Poverty gap at $1 a day (%)	..	..	6.3	..	..	..	6.3 (1997)	
Percentage share of income or consumption held by poorest 20%	..	7.6	7.6	..	..	..	7.6 (1997)	
Prevalence of child malnutrition (% of children under 5)	..	40	..	40	..	..	40 (2001)	
Population below minimum level of dietary energy consumption (%)	29.0	28.0	28.0	22.0	..	22.0	22.0 (2003)	[14.5]
2 Achieve universal primary education	2015 target = net enrollment to 100							
Net primary enrollment ratio (% of relevant age group)	61.4	70.0	80.2	82.8	..	85.0	85.0 (2003)	[100]
Percentage of cohort reaching grade 5 (%)	53.3	55.4	54.3	62.3	..	..	62.3 (2001)	[100]
Youth literacy rate (% ages 15-24)	70.1	74.0	..	78.6	79.3	80.0	80.0 (2003)	[100]
3 Promote gender equality	2005 target = education ratio to 100							
Ratio of girls to boys in primary and secondary education (%)	75.3	77.8	81.1	82.0	..	83.1	83.1 (2003)	[100]
Ratio of young literate females to males (% ages 15-24)	76.2	80.1	..	90.4	..	..	90.4 (2001)	[100]
Share of women employed in the nonagricultural sector (%)	42.1	..	..	..	..	..	42.1 (1990)	
Proportion of seats held by women in national parliament (%)	6	9	9	21	21	23	23 (2003)	
4 Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds							
Under 5 mortality rate (per 1,000)	163	134	..	105	100	91	91 (2003)	[54.3]
Infant mortality rate (per 1,000 live births)	120	105	..	90	87	82	82 (2003)	
Immunization, measles (% of children under 12 months)	32	68	67	50	55	42	42 (2003)	
5 Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths							
Maternal mortality ratio (modeled estimate, per 100,000 live births)	650	650	..	650	..	..	650 (2001)	[162.5]
Births attended by skilled health staff (% of total)	..	..	..	19.4	..	..	19.4 (2001)	
6 Combat HIV/AIDS, malaria and other diseases	2015 target = halt, and begin to reverse, AIDS, etc.							
Prevalence rate of HIV, females (% ages 15-24)	..	..	..	0.1	..	0.1	0.1 (2003)	[0.0]
Contraceptive prevalence rate (% of women ages 15-49)	..	25.1	..	..	..	..	32.0 (2000)	
Number of children orphaned by HIV/AIDS	..	..	..	280	..	..	280 (2000)	
Incidence of tuberculosis (per 100,000 people)	..	..	166.7	161.8	..	157.2	157.2 (2003)	[0.0]
Tuberculosis cases detected under DOTS (%)	..	24.0	33.5	38.0	43.3	47.1	47.1 (2003)	
7 Ensure environmental sustainability								
Forest area (% of total land area)	56.7	..	..	54.4	..	..	54.4 (2001)	
Nationally protected areas (% of total land area)	..	..	..	..	..	3.0	3.0 (2003)	
GDP per unit of energy use (PPP $ per kg oil equivalent)	..	..	..	..	..	..	..	
CO2 emissions (metric tons per capita)	0.1	0.1	0.1	0.1	..	..	0.1 (2001)	
Access to an improved water source (% of population)	..	..	..	37.0	..	43.0	43.0 (2003)	[74]
Access to improved sanitation (% of population)	..	..	..	30.0	..	24.0	24.0 (2003)	[60]
Access to secure tenure (% of population)	..	..	..	..	..	..	..	
8 Develop a Global Partnership for Development								
Youth unemployment rate (% of total labor force ages 15-24)	..	..	..	..	..	..	..	
Fixed line and mobile telephones (per 1,000 people)	1.6	3.9	6.1	15.2	21.2	32.0	32.0 (2003)	[Increase]
Personal computers (per 1,000 people)	..	1.1	1.6	3.0	3.3	3.5	3.5 (2003)	[Increase]
General indicators								
Population (millions)	4.1	4.7	4.9	5.4	5.5	5.7	5.7 (2003)	
Gross national income ($ billions)	0.8	1.7	1.9	1.6	1.7	1.9	1.9 (2003)	
GNI per capita ($)	200	370	380	300	310	340	390 (2004)	
Adult literacy rate (% of people ages 15 and over)	56.5	60.6	..	68.7	66.4	..	66.4 (2002)	
Total fertility rate (births per woman)	6	5.5	5.3	5.0	4.8	4.8	4.8 (2003)	
Life expectancy at birth (years)	49.7	51.8	52.5	53.7	54.5	54.7	54.7 (2003)	
Aid (% of GNI)	17.3	17.6	..	14.7	17.3	..	17.3 (2002)	
External debt (% of GNI)	204.3	123.2	..	150	165.2	..	165.2 (2002)	
Investment (% of GDP)	13.5	26.0	..	22.1	..	..	22.1 (2001)	
Trade (% of GDP)	35.8	60.6	65.2	..	..	50.8	50.8 (2003)	

Source: World Development Indicators database and World Bank, 2005.

Table 2. Lao P.D.R.: Regional Comparison of Selected Indicators 1/

	Lao P.D.R.	Cambodia	China	Thailand	Vietnam	East Asia & Pacific	Low-income	Sub-Saharan Africa
POPULATION								
Total population, mid-year (millions)	5.7	13.4	1,288.4	62.0	81.3	1,854.6	2,311.9	704.5
Growth rate (% annual average for period)	2.3	1.7	0.6	0.7	1.1	0.8	1.8	2.2
Urban population (% of population)	20.7	18.6	38.7	20.4	25.4	39.1	30.4	36.5
Total fertility rate (births per woman)	4.8	3.9	1.9	1.8	1.9	2.1	3.7	5.2
POVERTY								
(% of population)								
National headcount index	33.5	35.9	4.6	..	28.9	..	..	..
Urban headcount index	19.7	40.1	2.0	..	35.6	..	..	..
Rural headcount index	37.6	13.9	4.6	..	6.6	..	..	..
$ 1 a day headcount index	26	19	12	2	11	11	..	46
$ 2 a day headcount index	73	65	36	24	55	37	..	77
Human Development index	0.55	0.57	0.76	0.78	0.70	0.77	0.59	0.52
INCOME								
GNI per capita (US$)	390	300	1,100	2,010	480	1,070	440	500
Consumer price index (2000=100)	138	104	101	104	107	..	..	..
INCOME/CONSUMPTION DISTRIBUTION								
Gini index	37.0	40	45	43	37	..	..	..
Lowest quintile (% of income or consumption)	7.6	6.9	4.7	6.1	7.5	..	..	..
Highest quintile (% of income or consumption)	45.0	47.6	50.0	50.0	45.4	..	..	..
SOCIAL INDICATORS								
Public expenditure								
Health (% of GDP)	1.5	2.1	2.0	3.1	1.5	1.9	1.5	2.6
Education (% of GDP)	3.2	1.8	2.1	5.2	...	3.2	3.2	3.3
Adult literacy								
(% of people aged 15 and above)								
Total	66	69	91	93	90	90	61	65
Male	77	81	95	95	94	90	68	71
Female	56	59	87	91	87	86	48	58
Net primary school enrollment rate								
(% of age group)								
Total	85	93	95	86	94	93	77	...
Male	88	91	97	87	98	93	82	...
Female	82	96	94	85	92	94	72	...
Access to an improved water source								
(% of population)								
Total	43	34	77	85	73	78	75	58
Urban	66	58	92	95	93	92	89	82
Rural	38	29	68	80	67	69	70	46
Access to improved sanitation								
(% of population)								
Total	24	16	44	99	41	49	36	36
Urban	61	53	69	97	84	71	61	55
Rural	14	8	29	100	26	35	24	26
Immunization rate								
(% under 12 months)								
Measles	42	65	84	94	93	82	65	61
DPT	50	69	90	96	99	86	67	59
Prevalence of undernourishment (% of population)	22	33	11	20	19	12	25	32
Child malnutrition (% under 5 years)								
Height for age	41	45	14	13	37	17	43	...
Weight for age	40	45	10	18	34	15	44	...
Life expectancy at birth (years)								
Total	55	54	71	69	70	70	58	46
Male	54	53	69	67	68	68	57	45
Female	56	56	73	72	72	71	59	46
Mortality								
Infant (per 1,000 live births)	82	97	30	23	19	32	80	101
Under 5 (per 1,000 live births)	91	140	37	26	23	41	123	171
Adult (15-59)								
Male (per 1,000 population)	355	373	...	245	203	179	319	519
Female (per 1,000 population)	299	264	...	150	139	122	268	461
Maternal (modeled, per 100,000 live births)	650	450	56	44	130	116	689	917
Births attended by skilled health staff (%)	19	32	97	69	85	87	38	32

Source: World Bank (2005) and UNDP (2005).

1/ Latest year available.

LAO P.D.R.: JOINT FUND-BANK DEBT SUSTAINABILITY ANALYSIS

1. **This annex presents an updated comprehensive debt sustainability analysis (DSA) for Lao P.D.R.**[34] The DSA, which was prepared jointly with the World Bank, is based on the common standard framework for low-income countries approved by the Executive Boards of the IMF and IDA.[35] The annex also assesses the potential impact of the Multilateral Debt Relief Initiative (MDRI) on Lao P.D.R.

2. **The update confirms earlier findings that Lao P.D.R. remains in the category of low-income countries with a high risk of debt distress**. Provided that sufficient progress is made in economic reforms, the medium-term debt service outlook is manageable. However, there are significant risks, especially on the fiscal side, if the pace of reform remains slow. Debt relief under HIPC and MDRI would significantly reduce the external public debt burden, but its impact on net resource flows is more uncertain, as consequences for the country's access to new concessional financing from IDA and bilateral creditors is difficult to quantify. The authorities have not, to date, expressed interest in seeking debt relief under these initiatives.

A. Debt Sustainability Analysis

Background

3. **Although external public debt has been declining as a percent of GDP, it remains high** (Figure 1)**.** At end-2004, the latest date for which comprehensive data is available, the stock of external public debt amounted to $2.1 billion in nominal terms, with a net present value of $1.4 billion. At these levels, Lao P.D.R.'s debt stock indicators are significantly above the indicative thresholds for countries with similar CPIA rating (Text Table 1).

Text Table 1. Lao P.D.R.: External Public Debt Indicators

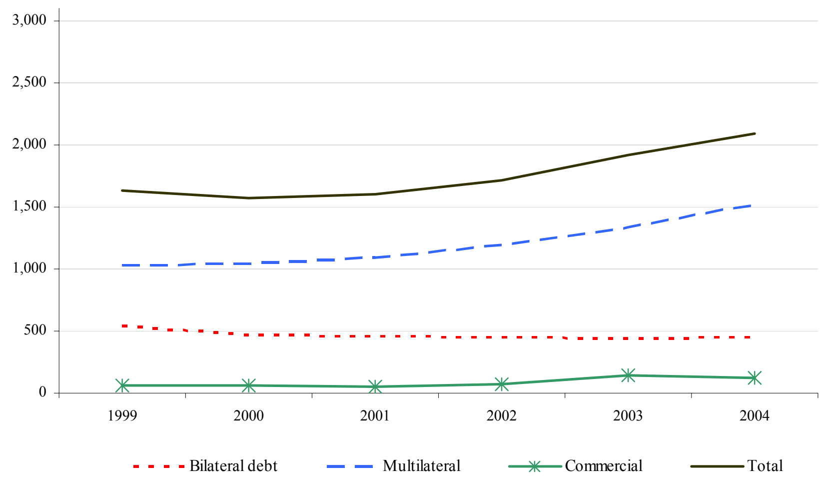
	Indicative Threshold	End-2004
NPV of debt in percent of		
GDP	30	55
Exports	100	199
Revenues	200	495

[34] The last comprehensive DSA for Lao P.D.R. was prepared in the context of the 2004 Article IV Consultation (IMF/Country Report No. 05/8).

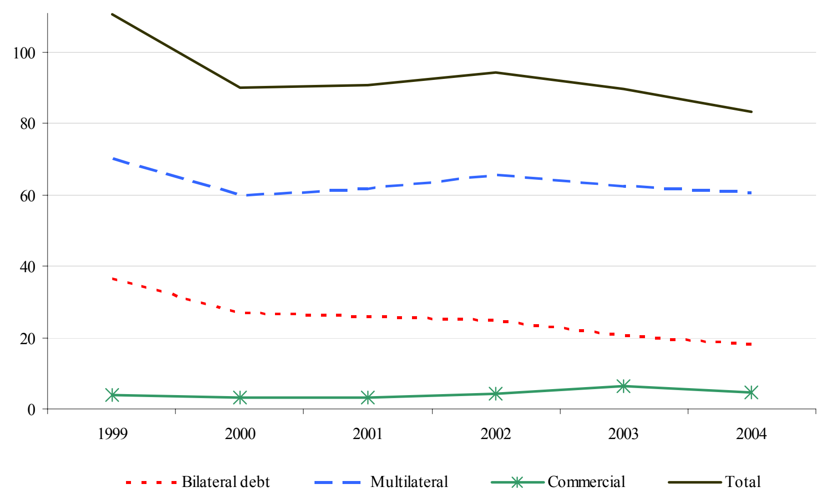
[35] Due to the negligible size of domestic public debt in Lao P.D.R. (1.5 percent of GDP in 2004) and a lack of sufficient information on the level and terms of private external debt obligations, the debt sustainability analysis focuses exclusively on external public and publicly guaranteed debt. The analysis employs a modified LIC DSA external template, which incorporates both fiscal and balance of payments indicators.

Figure 1. Lao P.D.R.: External Public and Publicly Guaranteed (PPG) Debt

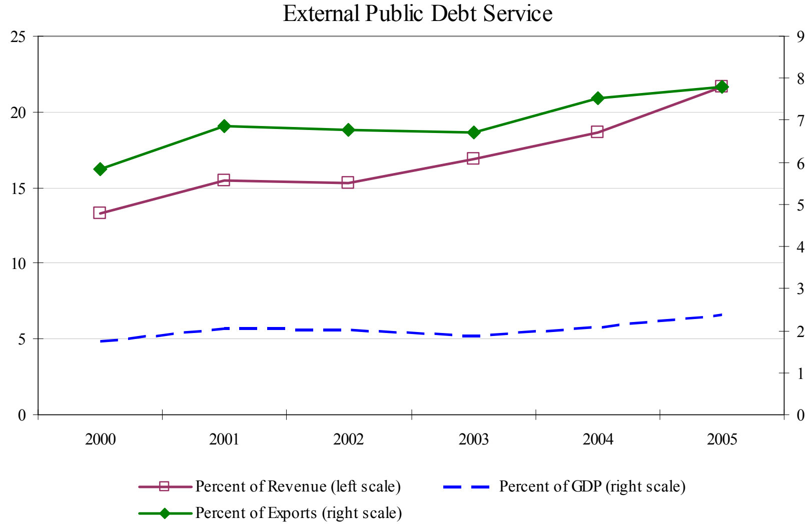
Nominal External PPG Debt (USD million)



Nominal External PPG Debt (percent of GDP)



External Public Debt Service



4. **Almost 75 percent of Lao P.D.R.'s debt is in the form of concessional loans from multilateral creditors, primarily the World Bank and the AsDB** (Table 1). Concessional borrowing from these two institutions accounts for the bulk of the increase in public external debt since 1999.[36] The two largest bilateral creditors are Russia and Japan, who account for 19 and 2 percent of the stock of public debt respectively.[37] The bulk of the external debt is owed by the central government, with state-owned enterprises accounting for slightly over 5 percent of the total debt stock.

5. **While the external debt service burden has remained at manageable levels due to a high degree of concessionality, it has been rising in recent years**. In the last 3 years, the debt service-to-revenue ratio has risen by 6.4 percentage points to 21.7 percent at end-2005, bringing it within reaching distance of the indicative threshold for low CPIA countries (25 percent). The debt service-to-export ratio has also risen, but much more modestly, and, at 7.8 percent, remains well within the indicative sustainability threshold (15 percent).

Medium-Term Macroeconomic Framework

6. **Achieving the government's development objectives will require an acceleration of structural reforms**. In addition to maintaining sound macroeconomic policies, stepped up efforts to mobilize revenues and reform the state-owned commercial banks are needed to ensure macroeconomic stability over the medium term. Sustaining high rates of economic growth will also require a concerted effort to strengthen the investment climate, to enable Lao P.D.R. to take advantage of the opportunities for economic integration in the region.

7. **The staff have prepared a medium-term economic outlook based on such a scenario** (Table 2). Under this reform scenario, economic growth would remain at around 6-7 percent between 2005–2010 (Text Table 2). The two large mining projects (Oxiana and Pan Australian)[38] and the construction

Text Table 2. Lao P.D.R.: Key Macroeconomic Assumptions
(In percent, unless stated otherwise)

Period average	2001–05	2006–10	2011–25
Real GDP growth	6.2	6.5	5.0
Export growth	7.0	10.4	7.0
Revenue (% of GDP)	11.8	12.4	13.6
Gross public borrowing (% of GDP)	6.1	5.5	4.0
Grant element of new borrowing	42.3	40.7	42.1

[36] Over 80 percent of the debt accumulated between 1999 and 2004 represents concessional loans from multilateral creditors, and about 15 percent represents SOE borrowing.

[37] To facilitate analysis, the stock of Russian debt prior to 2003 is valued at $387 million, in line with the agreement reached between Lao P.D.R. and Russian Federation in December 2003.

[38] These two gold and copper mining projects began operations in 2004–05 and are expected to reach full capacity in 2007.

of the Nam Theun 2 (NT2) hydroelectric dam are projected to contribute around 1½ percentage per year to growth during this period. Underlying growth would be sustained at 5 percent—close to the average for the past five years—as growth in agriculture, tourism and small-scale manufacturing, stimulated by trade reforms and improvements in the investment climate, offset slower growth in garments following the expiration of the MFA quota system.[39]

8. **A gradual consolidation of fiscal policy will be needed to ensure debt sustainability over the medium term** (Table 3)**.** Under the baseline scenario, the overall fiscal deficit would decline from 4 percent of GDP to around 3 percent of GDP by 2010. The fiscal consolidation will need to be driven largely by an improved revenue effort—revenue is projected to rise from 11.6 percent to 12.8 percent of GDP, in part due to increased mining royalties and taxes. Non-resource revenues would rise from 10.1 percent to 10.6 percent of GDP.[40] Primary expenditure is expected to remain broadly unchanged under this scenario at around 16 percent of GDP, with the composition shifting gradually from capital to recurrent spending (partly reflecting a gradual decline in foreign-financed capital expenditure). The wage bill is assumed to stabilize at 5.0 percent of GDP, to ensure adequate resources for non-wage operating expenses in the budget.

9. **The medium-term fiscal outlook would be underpinned by efforts to enhance non-resource revenues and improve the efficiency of spending.** The scenario assumes that progress will be made in the authorities' efforts to improve tax and customs administration, based on greater collaboration with the provinces, and that it would be complemented by additional revenue-generating initiatives, culminating with the introduction of a VAT towards the end of the decade.[41] These reforms are expected to offset any revenue losses from tariff reductions under the ASEAN Free Trade Agreement.[42] Expenditure reforms would focus most immediately on improving budget monitoring at the center and in the provinces and on enhancing budget preparation, through improving the timeliness and transparency of basic budget documents. The longer-term goal would be to establish a strong national treasury, with full control over national public finances, and build up the systems of

[39] The impact of the expiration of the MFA quota system on GDP growth is expected to be relatively modest as the garments sector's contribution to GDP (less than 1 percent) is relatively small, and the loss of market share in the EU should be partly offset by improved access to the U.S. markets following the granting of normal trade relations in November 2004.

[40] Excludes royalties and taxes from timber, mining, and hydro-power projects.

[41] The authorities aim to introduce a VAT in 2008/09. In the shorter run, tax reforms such as the introduction of a single rate turnover tax and reforms of excises on petroleum and other products (especially tobacco) have some revenue generating potential.

[42] Staff estimate the loss in revenue from AFTA at 0.5 percent of GDP, in the absence of any reduction in leakages in customs collections.

budget planning and execution to enable the allocation of public resources to be effectively aligned with the government's development goals.

10. **The external current account deficit, which will remain high (12–15 percent of GDP) in the next few years, is projected to decline sharply by the end of the decade**. Export volume growth is projected to rise sharply over the next 5 years—averaging 11 percent between 2005 and 2010—driven by increased gold and copper exports (and electricity once the NT2 dam comes on-stream in 2009/10). While the terms of trade are expected to deteriorate, reflecting mainly softer copper prices, export value growth is expected to average around 10 percent over the period. Initially, the increase in exports will be offset by higher imports associated with the construction of the NT2 dam. However, the current account deficit should start to decline sharply from 2007 onwards as these capital outlays wind down. Although the improvement in the current account deficit will be largely offset by higher capital outflows, associated with the repayment of NT2-related loans and the repatriation of mining profits, the net inflows from these projects should be sufficient to sustain external reserves at around 3-3½ months of imports.

Debt Outlook

11. **The baseline scenario suggests that achieving long-term debt sustainability is feasible** (Figure 2 and Tables 4.a.-c.)**.** While external public debt will remain at elevated levels throughout the projection period, the main debt-stock indicators are projected to decline steadily and approach the indicative thresholds by the end of the projection period (Text Table 3).[43] This relatively favorable debt profile hinges on the following key assumptions: (i) that robust GDP and export growth will be sustained, which in the longer-term will depend on improving Lao P.D.R.'s investment climate; (ii) progress is made in mobilizing revenues; (iii) public borrowing declines over the medium term;[44] and (iv) the authorities maintain a high level of concessionality on new borrowing.

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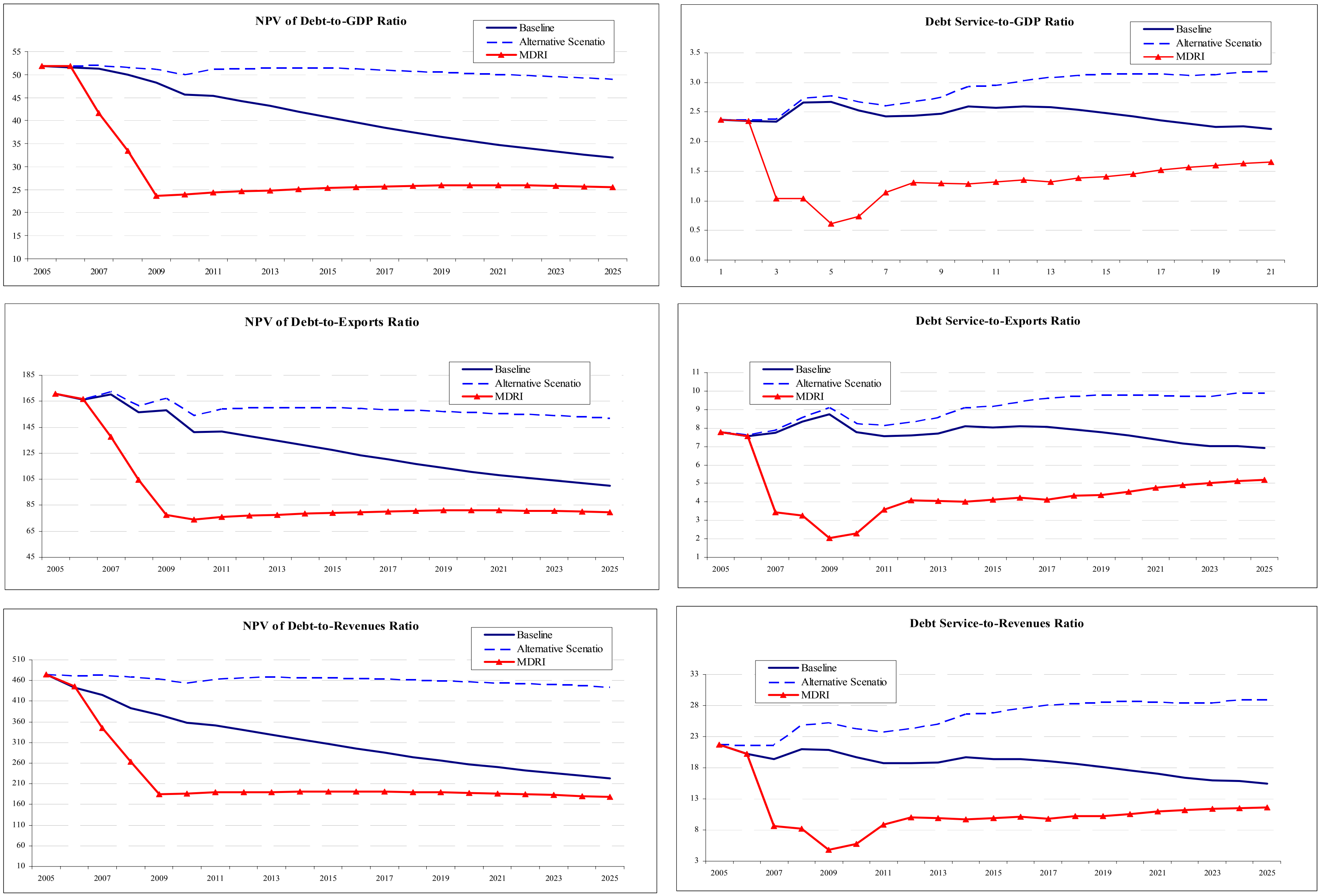
[43] Under the baseline scenario, Lao P.D.R.'s NPV of debt-to-export ratio would fall below the HIPC threshold of 150 percent in 2008/09.

[44] The scenario assumes that the Russian debt will be serviced according to the preliminary agreement reached in December 2003. Discussions on the agreement are currently ongoing, which, if successful, could alleviate some of the increase in debt service over the next few years.

Figure 2. Lao P.D.R.: Debt Sustainability Analysis of External Public and Publicly Guaranteed Debt, 2005-2025



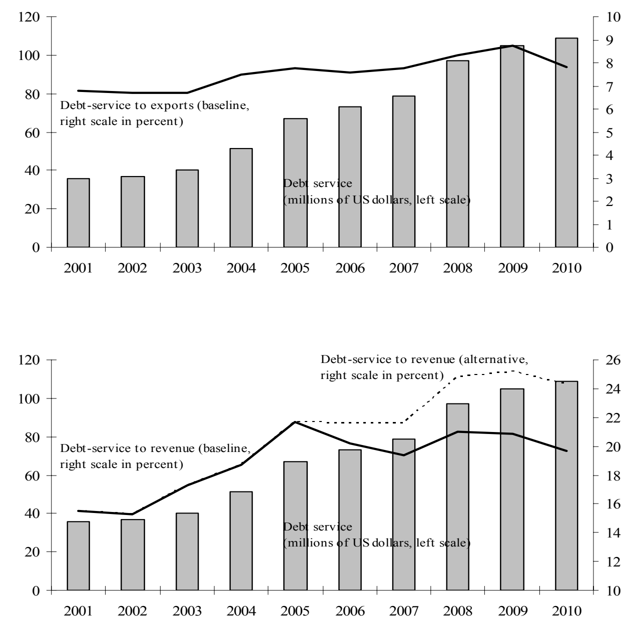
Text Table 3. Lao P.D.R.: Debt Sustainability Indicators Under Various Scenarios

	Indicative Threshold 1/	Baseline			Alternative Scenario		MDRI	
		2005	2025	Average, 2005–2025	2025	Average, 2005–2025	2025	Average, 2005–2025
NPV of debt in percent of								
GDP	30	52	32	41	49	51	25	29
Exports	100	171	100	130	152	160	80	92
Revenues	200	475	224	318	445	462	178	224
Debt service in percent of								
Exports	15	8	7	8	10	9	5	4
Revenues	25	22	15	19	29	26	12	11

1/ In 2004, Lao P.D.R. fell in the "poor performer" category in the World Bank's Country Policy and Institutional Assessment Index (CPIA).

12. **Despite a two-fold increase in debt service between 2004 and 2010, the debt service-to-exports ratio is expected to remain at manageable levels** (Figure 3).[45] This reflects mainly the fact that the rise in debt service will coincide with a period of rapid export growth, as the gold and copper mining (and later NT2) projects come on stream. As a result, the debt service-to-export ratio is expected to remain at around 8-9 percent, well within the indicative thresholds. In the longer term, continued private sector development and growth in the energy sector, combined with prudent debt management, are expected to keep the debt service-to-exports ratio at modest levels.

Figure 3. Lao P.D.R. Projected External Public Debt Service



13. **The outlook on the fiscal side is more precarious.** Although the debt service-to-revenue ratio is projected to remain within the indicative thresholds, they remain elevated throughout the medium term, and significantly above levels in recent years. The margin for slippage on the fiscal side is therefore much narrower than on the external side.

[45] Of the total projected increase in debt service between 2005 and 2010, 47 percent represents higher repayments of concessional loans from multilateral creditors, about 23 percent are payments to Paris Club creditors and 30 percent is due to the repayment of commercial debt.

Risks and Vulnerabilities

14. **The medium-term outlook is susceptible to several risks.** The main risk is that the pace of structural reform will remain slow and tentative, especially on the fiscal side. Although the economy will still receive a significant stimulus from the large natural resource sectors, a slow pace of reforms to improve the trade and investment environment would weaken the growth outlook for the underlying economy. On the fiscal side, the main risk is that higher resource revenues may be seen as a substitute for undertaking difficult reforms to mobilize non-resource revenues, limiting improvement in the overall revenue effort.[46] With the fiscal space constrained by a weak revenue effort, fiscal consolidation would be more difficult and there could be pressure to maintain high levels of borrowing to finance Lao P.D.R.'s development needs.

15. **Staff have factored these risks into an alternative scenario, characterized by limited progress in structural reforms.** The alternative scenario assumes lower GDP and export growth, weaker revenue performance and a higher level of borrowing. Specifically, the growth rate of exports and GDP is one percentage point lower than in the baseline scenario, revenues remain stagnant at their 2005 level of 11.3 percent of GDP, and borrowing is not reduced over time, remaining at its recent level of 6 percent of GDP.

16. **The debt outlook under such a "muddle-through" scenario is significantly less benign, especially on the fiscal side.** The decline in debt stock ratios is much less pronounced, and they remain well above the indicative sustainability thresholds throughout the projection period. The debt service burden is also considerably higher. While the debt service-to-export ratio is expected to remain at manageable levels even under the alternative scenario, the debt service-to-revenue ratio rises significantly above the indicative threshold, suggesting the possibility of debt distress.

17. **The standardized stress tests of the low-income DSA template broadly confirm these risks** (Table 4.c.). In particular, they highlight the importance of containing the volume, and ensuring high concessionality, of new borrowing. It would be critical to limit borrowing on less concessional terms to projects with firm financial viability. Assessing such viability in a transparent manner and through reputable sources will be important in maintaining donors' confidence in government policies. However, some stress tests are not that well suited to analyzing risks to Lao P.D.R.'s debt sustainability. For example, while setting export growth at historical average minus one standard deviation in 2006–07 (bound test B2) has a larger impact on debt ratios in 2006–2015 than the alternative scenario, such a shock is unlikely due to the planned expansion of mining operations, which are projected to

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[46]The projection for mining revenues is also subject to some uncertainty. While they are based on conservative commodity price assumptions, the parameters for profit taxes had to be estimated, as they are confidential. It is also assumed that the provinces will fully remit these revenues to the center.

considerably raise exports in 2007. A more plausible risk is that trend growth in exports over the longer-term will be slower than assumed in the baseline scenario.

B. Multilateral Debt Relief Initiative (MDRI)

Background

18. **Lao P.D.R. is eligible for debt relief under the HIPC Initiative and the MDRI.** It qualifies under the export window, as the NPV of its external public debt was 197 percent of exports at end-2004,[47] well above the HIPC Initiative threshold of 150 percent. If Lao P.D.R. were to participate in this process, it could receive debt relief through three channels: (i) traditional debt relief mechanisms, through which Lao P.D.R. would be eligible for rescheduling on its bilateral debt; (ii) debt relief under the HIPC Initiative, which would aim to reduce the NPV of Lao P.D.R.'s external public debt to 150 percent of exports; and (iii) debt relief from the IMF and IDA under the MDRI.

19. **The timing of any debt relief under the HIPC/MDRI initiatives would depend on how fast Lao P.D.R. could reach a completion point under the HIPC initiative**. There would be three basic steps in this process:

- The first step would be to negotiate a new PRGF program, a necessary condition for participating in the HIPC initiative.
- Once a new PRGF program is approved, Lao P.D.R. would need to build a track record to reach a decision point under the HIPC initiative. Provided Lao P.D.R. demonstrates strong performance and commitment to macroeconomic policies and structural reforms, it could build such a track record in 6-12 months.
- The timing of the completion point, when the MDRI relief would be received, would depend on meeting the completion point criteria. The average time between decision and completion points has been about 2-3 years.

20. **There is a risk that Lao P.D.R. might become ineligible for HIPC/MDRI debt relief, if the decision point is significantly delayed.** Exports are expected to rise considerably over the next three years, mainly because of higher mining exports, and this could push the debt-to-exports ratio below the 150 percent threshold. In such an event, Lao P.D.R. would no longer be eligible for either HIPC or MDRI debt relief.

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[47] After assumed application of traditional debt relief. The calculation is based on HIPC DSA methodology. Pending further information, it also assumes an SDR discount rate on AsDB debt.

Potential Impact on Debt Sustainability

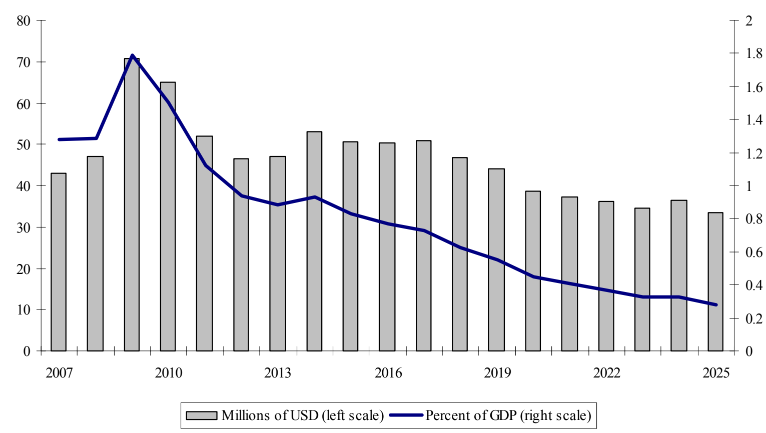
21. **Staff have prepared an illustrative scenario based on the assumption of a HIPC decision point in 2007 and a completion point in 2009.** The basic assumptions are the same as for the baseline scenario discussed above, with the exception that the scenario has, for illustrative purposes, lowered public sector borrowing by 0.5 percent of GDP compared to the baseline, to reflect the possible impact of a lower gross IDA allocation and a lower access to concessional loans from some bilateral creditors (see paragraph 23).

22. **The main results of this illustrative MDRI scenario are as follows:**

- **Lao P.D.R.'s external public debt would be substantially reduced.** The NPV of debt-to-GDP ratio would fall to around 30 percent after Lao P.D.R. received the full MDRI debt relief at the HIPC completion point. The bulk of the debt relief would come from the cancellation of the IDA debt borrowed before end-2003 and traditional debt relief from Lao P.D.R.'s bilateral creditors (Table 5).

- **Lao P.D.R.'s debt service burden would also be significantly lower** (Figure 4). Staff estimate that the debt service savings could be of the order of 1-2 percent of GDP in 2007-2015. These savings would start as soon as Lao P.D.R. started to receive HIPC interim debt relief once it reached the decision point.

Figure 4. Lao P.D.R. Projected Debt Service Savings under the MDRI 1/



1/ Based on end-2006 debt stock.

23. **Notwithstanding the potentially substantial reduction in the debt service burden, the impact on net resource flows to Lao P.D.R. remains uncertain**. In particular, the authorities are concerned that gross resource inflows could be reduced by more than the 0.5 percent of GDP assumed in the illustrative scenario. In addition to receiving a lower IDA allocation under the MDRI, participating in the HIPC Initiative may negatively affect Lao P.D.R.'s access to concessional loans from bilateral creditors. It might also disrupt disbursements for large hydro sector projects, whose creditors had previously received assurances that Lao P.D.R. would not seek HIPC debt relief.

Table 1. Lao P.D.R.: External Debt and Debt Service 2003–2010 1/

	2003	2004	2005	2006	2007	2008	2009	2010
		Est.	Projections					
	(In millions of U.S. dollars)							
Total debt stock (public and private)	2,171	2,530	2,910	3,179	3,428	3,652	3,788	3,802
Public debt	1,915	2,086	2,225	2,416	2,569	2,698	2,802	2,899
Bilateral official	437	453	476	506	525	549	565	581
of which: Russian Federation 2/	387	387	385	382	379	376	372	367
Japan	39	45	60	76	89	109	123	138
Multilateral	1,338	1,516	1,621	1,759	1,859	1,945	2,034	2,114
of which:								
AsDB	715	754	810	871	922	969	1,025	1,078
IDA	485	618	649	684	725	758	789	815
IMF	46	38	32	28	25	21	15	10
Commercial	140	117	127	151	185	203	203	204
Private debt	257	444	685	762	860	954	986	903
Amortization	56	70	83	147	149	131	140	178
Public debt	28	29	41	46	50	67	73	76
Bilateral official	2	2	3	6	6	6	8	9
of which: Russian Federation 2/	0	1	2	3	3	3	4	5
Japan	0	0	0	2	2	2	2	2
Multilateral	26	22	29	29	32	40	45	48
of which:								
AsDB	8	9	11	13	15	18	20	22
IDA	7	8	9	10	11	14	15	16
IMF	9	3	6	3	3	4	6	6
Commercial	0	4	9	11	11	20	20	19
Private debt	27	41	41	101	100	64	67	103
Interest payments	35	49	100	97	111	114	91	112
Public debt	12	22	26	27	29	30	32	34
Bilateral (official debt)	1	5	9	10	10	10	11	11
of which: Russian Federation 2/	0	4	9	9	9	9	9	9
Japan	0	0	1	1	1	1	1	1
Multilateral	11	16	14	15	15	16	17	18
of which:								
AsDB	6	9	8	8	9	9	10	11
IDA	4	6	5	5	5	6	6	6
IMF	0	0	0	0	0	0	0	0
Commercial	0	2	2	3	3	4	4	4
Private debt	23	27	75	70	82	84	59	78
	(In percent of GDP)							
Total debt service	4	5	6	8	8	7	6	7
of which: public debt	2	2	2	2	2	3	3	3
Total debt stock	102	101	103	102	102	100	96	88
of which: public debt	90	83	79	78	77	74	71	67
	(In percent of exports of goods and services)							
NPV of public external debt	205	199	171	166	170	157	158	141
Total debt service	15	17	21	25	26	21	19	21
of which: public debt	6.7	7.5	7.8	7.6	7.7	8.3	8.8	7.8
Memorandum items:								
NPV of public external debt 3/	1,223	1,366	1,467	1,602	1,723	1,823	1,900	1,976
Debt service (percent of revenues)	17.3	18.7	21.7	20.2	19.4	21.0	20.9	19.1
Nominal GDP	2,138	2,501	2,828	3,104	3,358	3,651	3,941	4,323
Exports of goods and services	598	687	860	965	1,013	1,165	1,202	1,400

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

1/ The numbers may not add up due to rounding.
2/ Based on the December 2003 agreement between Russian and Lao authorities.
3/ Uses an SDR discount rate for AsDB loans.

Table 2. Lao P.D.R.: Summary Macroeconomic Framework, 2003–2010

	2003	2004	2005	2006	2007	2008	2009	2010
			Projections					
Output and Prices (percent change)								
Real GDP	6.1	6.4	7.0	7.1	6.0	6.5	5.7	7.4
(excluding NT2 and large mining projects)	4.2	6.1	4.2	4.8	4.9	5.1	5.0	5.0
Consumer prices (end period)	12.6	8.7	8.8	5.0	5.0	5.0	5.0	5.0
Consumer prices (period average)	15.5	10.5	7.2	6.8	5.0	5.0	5.0	5.0
Savings and investment balance (in percent of GDP) 1/								
Gross fixed investment	25.7	31.8	32.5	32.2	34.5	30.5	29.6	26.7
Gross national savings	17.5	17.3	16.1	19.5	19.7	20.8	21.7	22.3
Foreign savings (including official transfers)	8.1	14.4	16.4	12.7	14.7	9.7	7.9	4.4
Public Finances (in percent of GDP) 2/								
Revenue	10.9	11.0	10.9	11.6	12.0	12.7	12.8	12.8
Grants	2.1	1.1	1.4	1.5	1.4	1.4	1.8	1.5
Expenditure	18.6	15.5	15.9	17.1	17.3	17.4	17.5	17.2
Overall balance	-5.7	-3.4	-3.5	-4.0	-3.9	-3.3	-3.0	-3.0
Government debt	95.7	84.6	77.3	73.8	73.1	70.5	68.0	64.6
Debt service (in percent of revenue)	13.8	16.4	16.3	18.6	17.1	16.1	16.8	16.7
Trade and Prices (percent change)								
Export volume growth	-3.6	5.6	14.7	11.3	5.8	16.0	4.1	16.4
(excluding NT2 and large mining projects)	-10.8	7.6	7.6	4.8	2.1	9.2	4.1	-0.5
Import volume growth	17.0	28.2	9.6	4.3	8.1	-3.0	-0.5	0.2
(excluding NT2 and large mining projects)	9.6	4.1	5.7	3.4	4.2	4.7	4.7	4.9
Terms-of-trade (percent change)	6.8	0.8	2.8	-2.9	-2.4	-2.4	-2.7	-1.7
Balance of Payments (in millions of US dollars)								
Current Account Balance	-174	-361	-464	-394	-494	-354	-312	-188
Trade balance	-244	-478	-483	-490	-582	-421	-417	-264
Services and income (net)	-17	31	-74	-15	-29	-55	-20	-61
Transfers	87	85	93	111	116	121	125	137
Capital Account Balance	196	379	470	418	520	381	340	217
Official	118	118	150	192	152	120	104	97
Private	100	300	274	240	382	277	253	138
Overall Balance	22	18	7	24	25	26	28	29
External Public Debt								
in millions of US dollars (end period)	1,915	2,086	2,225	2,416	2,569	2,698	2,802	2,899
in percent of GDP (end period)	90	83	79	78	77	74	71	67
Net present value (in percent of exports)	205	199	171	166	170	157	158	141
External Public Debt service								
in millions of U.S. dollars	40	52	67	73	79	97	105	109
in percent of exports	6.7	7.5	7.8	7.6	7.7	8.3	8.8	7.8
Gross Official Reserves								
in millions of U.S. dollars	214	227	229	250	275	302	329	359
in months of imports 3/	3.7	3.4	3.0	3.0	3.2	3.3	3.4	3.4
Memorandum items:								
Nominal GDP (billions of Kip)	22,598	26,540	30,237	34,216	38,065	42,566	47,247	53,294
Nominal GDP (millions of U.S. dollars)	2,138	2,501	2,828	3,104	3,358	3,651	3,941	4,323

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

1/ Estimates for private savings and investment are highly tentative as no expenditure based national accounts have yet been established. In particular, private savings reflect unrecorded imports.
2/ Fiscal year basis (October to September); numbers are based on staff proposal for 2005 and 2006, and projections for 2007-2010.
3/ Excludes imports associated with NT2 and the large Oxiana and Pan Australian mining projects.

Table 3. Lao P.D.R.: Medium-Term Fiscal Projections
(In percent of GDP, unless otherwise specified)

	Fiscal year 1/	2004	2005	2006	2007	2008	2009	2010
Nominal GDP	KN billion	25,555	29,313	33,222	37,103	41,441	46,077	51,782
Real GDP Growth	Annual rate	6.3	6.8	7.6	6.2	6.4	5.9	7.0
GDP deflator inflation	Annual rate	11.6	7.4	5.3	5.0	5.0	5.0	5.0
Real effective exchange rate	2000 = 100	101	103	103	103	103	103	103
Main results								
FISCAL ACCOUNTS								
Revenues and grants		12.1	12.4	13.1	13.4	14.1	14.5	14.2
Revenue		11.0	10.9	11.6	12.0	12.7	12.8	12.8
Tax		9.1	9.1	9.8	10.2	10.9	10.9	10.9
Resource 2/		1.1	1.2	1.5	1.7	2.4	2.3	2.2
Other		8.0	7.8	8.3	8.4	8.5	8.6	8.7
Non-tax		1.9	1.9	1.8	1.8	1.8	1.8	1.8
Grants		1.1	1.4	1.5	1.4	1.4	1.8	1.5
Primary expenditure		14.6	15.0	16.0	16.1	16.3	16.4	16.1
Current (excld. interest)		6.5	7.2	8.1	8.4	8.6	8.7	8.7
Wages		4.2	4.5	5.0	5.0	5.0	5.0	5.0
Non-wage recurrent		2.3	2.7	3.1	3.4	3.6	3.7	3.7
Capital		8.1	7.8	7.9	7.8	7.7	7.7	7.5
Domestic 3/		3.6	2.8	2.4	2.5	2.9	3.1	3.2
External		4.6	4.9	5.5	5.3	4.9	4.6	4.2
Primary Balance		-2.5	-2.6	-2.9	-2.8	-2.2	-1.9	-1.9
Interest		0.9	0.9	1.0	1.1	1.1	1.1	1.1
Domestic		0.2	0.1	0.2	0.4	0.4	0.4	0.4
External		0.8	0.8	0.8	0.8	0.7	0.7	0.7
Overall balance		**-3.4**	**-3.5**	**-4.0**	**-3.9**	**-3.3**	**-3.0**	**-3.0**
Financing								
Gross requirements		4.7	4.4	5.7	5.2	4.6	4.3	4.3
Deficit		3.4	3.5	4.0	3.9	3.3	3.0	3.0
Amortization		0.9	0.9	1.1	0.9	0.9	1.0	1.1
External		0.9	0.9	1.1	0.9	0.9	1.0	1.1
Bank restructuring		0.4	0.0	0.6	0.4	0.3	0.3	0.3
Sources								
External		4.5	4.2	5.1	4.8	4.4	4.0	3.6
Domestic		0.2	0.2	0.6	0.4	0.2	0.2	0.7
Bonds		0.4	0.0	0.6	0.4	0.2	0.2	0.5
Other		-0.3	0.2	0.0	0.0	0.0	0.0	0.2
DEBT								
Total		**84.6**	**77.3**	**73.8**	**73.1**	**70.5**	**68.0**	**64.6**
External		83.0	75.3	72.1	71.5	69.1	66.7	63.5
In billions of U.S. dollar		2.0	2.1	2.2	2.4	2.5	2.6	2.7
Domestic		1.5	1.9	1.7	1.5	1.4	1.2	1.1
Memorandum items:								
External financing (in millions of dollars)								
Grants		27	40	44	46	49	69	62
Loans		111	116	155	158	157	157	154
Domestic bonds (billions of Kip)		114	6	200	151	89	114	247
Interest payments/revenue (in percent)		8.3	8.4	8.9	9.5	8.7	8.7	8.4
Debt service / revenue (in percent)		16.4	16.3	18.6	17.1	16.1	16.8	16.7
Gold price ($/oz)		409	434	453	475	495	515	535
Copper price ($/tonne)		2,863	3,550	3,313	2,975	2,750	2,500	2,400

1/ Fiscal year ending in September.
2/ Royalties and taxes from timber, mining and hydro-power projects.
3/ Includes onlending, debt repayment and contingency.

Table 4.a. Lao P.D.R. Sustainability Analysis of External Public and Publicly Guaranteed Debt, 2005–2025

	2004	2005	2006	2007	2008	2009	2010	2006-10 Average	2015	2025	2011–25 Average
a) External Public Debt Stock											
1. NPV of debt to GDP					(In percent of GDP)						
Baseline	54.6	51.9	51.6	51.3	49.9	48.2	45.7		40.8	32.0	
Alternative Macroeconomic Scenario 1/	54.6	51.9	51.9	52.0	51.5	51.1	50.0		51.3	48.9	
MDRI 2/	54.6	51.9	51.8	41.6	33.4	23.6	23.9		25.3	25.5	
2. NPV of debt to exports											
Baseline	198.9	170.6	166.0	170.0	156.5	158.1	141.1		127.3	99.9	
Alternative Macroeconomic Scenario 1/	198.9	170.6	166.7	172.2	161.4	167.3	154.0		159.9	152.1	
MDRI 2/	198.9	170.6	166.7	137.7	104.8	77.5	73.9		79.1	79.6	
3. NPV of debt to revenues											
Baseline	495	475	443	426	394	377	357		306	224	
Alternative Macroeconomic Scenario 1/	495	475	471	473	469	464	454		467	445	
MDRI 2/	495	475	445	345	264	185	187		191	178	
b) External Public Debt Service											
1. Debt service to exports					(In percent of exports of goods and services)						
Baseline	7.5	7.8	7.6	7.7	8.3	8.8	7.8		8.0	6.9	
Alternative Macroeconomic Scenario 1/	7.5	7.8	7.6	7.9	8.5	9.1	8.2		9.2	9.9	
MDRI 2/	7.5	7.8	7.6	3.4	3.3	2.0	2.3		4.1	5.2	
2. Debt service to revenues					(In percent of fiscal revenues excluding grants)						
Baseline	18.7	21.7	20.2	19.4	21.0	20.9	19.7		19.4	15.5	
Alternative Macroeconomic Scenario 1/	18.7	21.7	21.6	21.6	24.8	25.2	24.3		26.8	28.9	
MDRI 2/	18.7	21.7	20.2	8.6	8.2	4.8	5.8		9.9	11.6	
Memorandum Items					(In millions of US$, unless indicated otherwise)						
Real GDP growth (percent)											
Baseline	6.4	7.0	7.1	6.0	6.5	5.7	7.4	6.5	5.0	5.0	5.0
Alternative	6.4	7.0	6.1	5.0	5.5	4.7	6.4	5.5	4.0	4.0	4.0
Growth of US dollar value of exports (percent)											
Baseline	14.9	25.2	12.2	5.0	15.0	3.2	16.5	10.4	7.1	7.1	6.9
Alternative	14.9	25.2	11.2	4.0	14.0	2.2	15.5	9.4	6.1	6.1	5.9
NPV of Public Debt											
Baseline	1,366	1,467	1,602	1,723	1,823	1,900	1,976		2,483	3,871	
Alternative	1,366	1,467	1,595	1,713	1,829	1,938	2,060		2,844	4,891	
MDRI	1,366	1,467	1,609	1,396	1,221	931	1,034		1,544	3,082	
Public Debt Service											
Baseline	51.6	66.9	73.0	78.5	97.1	105.2	109.1	92.6	156.9	268.0	187.9
Alternative	51.6	66.9	73.0	78.3	96.9	105.3	110.0	92.7	163.2	318.3	208.4
MDRI	51.6	66.9	73.0	34.9	37.9	24.4	31.9	40.4	80.6	200.5	114.0
Gross PPG borrowing (in percent of GDP)											
Baseline	6.3	6.4	7.7	6.0	5.1	4.5	4.0	5.5	4.0	4.0	4.0
Alternative	6.3	6.4	7.4	6.0	6.0	6.0	6.0	6.3	6.0	6.0	6.0
MDRI	6.3	6.4	7.7	5.5	4.6	4.0	3.5	5.1	3.5	3.5	3.5
Fiscal revenues (in percent of GDP)											
Baseline	11.0	10.9	11.6	12.1	12.7	12.8	12.8	12.4	13.3	14.3	13.6
Alternative	11.0	10.9	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0

1/ From 2006 onwards growth rates of GDP and exports are lowered by one percent. Fiscal revenues are kept at 11 percent of GDP. Gross public borrowing stays at present level (6 percent of GDP) .
2/ Assumes a decision point in 2007 and a completion point in 2009. Traditional debt relief was applied with a cut-off date in June 1999. Calculations are based on end-2004 discount and exchange rates. MDRI delivery was based on remaining end-2003 debt to IDA and end-2004 debt to IMF.

Table 4.b. Lao P.D.R. External Debt Sustainability Framework, Baseline Scenario, 2004–2025 1/
(In percent of GDP, unless otherwise indicated)

	Estimate	Projections								
							2006–10			2011–25
	2004	2005	2006	2007	2008	2009	2010	Average	2015	2025	Average
External debt (nominal) 1/	**83.4**	**78.7**	**77.8**	**76.5**	**73.9**	**71.1**	**67.1**		**57.9**	**46.6**	
Change in external debt	-8.6	-4.8	-0.8	-1.3	-2.6	-2.8	-4.0		-1.7	-0.7	
Identified net debt-creating flows	-11.4	-0.2	1.1	0.3	-1.0	-1.0	-2.3		-0.5	0.2	
Non-interest current account deficit	**13.6**	**14.5**	**10.9**	**13.0**	**8.0**	**6.2**	**2.7**		**2.1**	**2.4**	2.3
Deficit in balance of goods and services	13.8	11.2	10.0	11.5	5.8	4.9	0.5		2.2	2.2	
Exports	27.5	30.4	31.1	30.2	31.9	30.5	32.4		32.0	32.0	
Imports	41.3	41.6	41.0	41.7	37.7	35.4	32.9		34.3	34.3	
Net current transfers (negative = inflow)	-3.4	-3.3	-3.6	-3.5	-3.3	-3.2	-3.2		-3.3	-3.3	-3.3
Other current account flows (negative = net inflow)	3.2	6.6	4.5	4.9	5.5	4.5	5.3		3.2	3.4	
Net FDI (negative = inflow)	**-12.5**	**-10.5**	**-5.6**	**-9.2**	**-5.2**	**-4.1**	**-0.9**		**-0.7**	**-0.6**	-0.7
Endogenous debt dynamics 2/	**-12.5**	**-4.2**	**-4.2**	**-3.4**	**-3.7**	**-3.1**	**-4.0**		**-1.9**	**-1.6**	
Contribution from nominal interest rate	0.9	0.9	0.9	0.9	0.8	0.8	0.8		0.9	0.6	
Contribution from real GDP growth	-5.0	-5.1	-5.1	-4.3	-4.6	-3.9	-4.8		-2.8	-2.2	
Contribution from price and exchange rate changes	-8.4	-1.5	-1.3	-1.3	-1.2	-1.2	-1.2		…	…	
Residual (2-3) 3/	**2.7**	**-4.5**	**-1.9**	**-1.6**	**-1.6**	**-1.8**	**-1.7**		**-1.2**	**-0.9**	
o/w exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
NPV of external debt 4/	**54.6**	**51.9**	**51.6**	**51.3**	**49.9**	**48.2**	**45.7**		**40.8**	**32.0**	
In percent of exports	198.9	170.6	166.0	170.0	156.5	158.1	141.1		127.3	99.9	
Debt service-to-exports ratio (in percent)	7.5	7.8	7.6	7.7	8.3	8.8	7.8		8.0	6.9	
Total gross financing need (millions of U.S. dollars)	79.2	180.0	238.5	203.3	198.3	189.2	184.0		243.5	483.5	
Non-interest current account deficit that stabilizes debt ratio	22.3	19.3	11.8	14.3	10.6	9.0	6.7		3.8	3.1	
Key macroeconomic assumptions											
Real GDP growth (in percent)	6.4	7.0	7.1	6.0	6.5	5.7	7.4	6.5	5.0	5.0	5.0
GDP deflator in U.S. dollar terms (change in percent)	10.0	5.7	2.5	2.1	2.1	2.1	2.1	2.2	2.0	2.0	2.0
Effective interest rate (percent) 5/	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.6	1.5	1.5
Growth of exports of G&S (U.S. dollar terms, in percent)	14.9	25.2	12.2	5.0	15.0	3.2	16.5	10.4	7.1	7.1	7.0
Growth of imports of G&S (U.S. dollar terms, in percent)	38.4	13.9	8.3	9.9	-1.7	1.2	2.0	4.0	7.1	7.1	7.4
Grant element of new public sector borrowing (in percent)	...	42.3	40.1	37.3	40.0	42.3	42.1	40.4	42.1	42.1	42.1
Memorandum item:											
Nominal GDP (millions of U.S. dollars)	2,501	2,828	3,104	3,358	3,651	3,941	4,323		6,091	12,095	

Source: Staff simulations.
1/ Includes public and publicly guaranteed (PPG) 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/ Uses average financing terms and end-2004 exchange rates.
5/ Current-year interest payments devided by previous period debt stock.

Table 4.c. Lao P.D.R.: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2004–2025
(In percent)

	Estimate		Projections										
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	**2015**	2025
NPV of debt-to-GDP ratio													
Baseline	55	52	52	51	50	48	46	45	44	43	42	**41**	32
New public sector loans on less favorable terms in 2006–25 1/	55	52	54	55	55	54	53	53	53	53	52	**52**	49
Bound Tests													
B1. Real GDP growth at historical average minus one standard deviation in 2006–07	55	52	53	53	51	49	47	47	46	44	43	**42**	33
B2. Export value growth at historical average minus one standard deviation in 2006–07 2/	55	52	54	57	56	54	51	51	49	48	47	**45**	34
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006–07	55	52	54	55	54	52	49	49	48	47	45	**44**	34
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 3/	55	52	55	60	58	56	53	53	51	50	49	**47**	34
B5. Combination of B1-B4 using one-half standard deviation shocks	55	52	57	63	61	59	56	56	54	53	51	**50**	38
NPV of debt-to-exports ratio													
Baseline	199	171	166	170	157	158	141	142	138	135	131	**127**	100
New public sector loans on less favorable terms in 2006–25 1/	199	171	173	183	172	178	162	166	165	164	163	**162**	154
Bound Tests													
B1. Real GDP growth at historical average minus one standard deviation in 2006–07	199	171	166	170	157	158	142	142	139	136	132	**128**	100
B2. Export value growth at historical average minus one standard deviation in 2006–07 2/	199	171	201	236	217	219	196	196	191	187	181	**175**	130
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006–07	199	171	166	170	157	158	142	142	139	136	132	**128**	100
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 3/	199	171	177	199	183	184	165	165	161	157	152	**147**	107
B5. Combination of B1-B4 using one-half standard deviation shocks	199	171	192	214	197	199	178	178	174	170	165	**160**	120
Debt service-to-exports ratio													
Baseline	7.5	7.8	7.6	7.7	8.3	8.8	7.8	7.6	7.6	7.7	8.1	**8.0**	6.9
New public sector loans on less favorable terms in 2006–25 1/	7.5	7.8	7.6	8.0	8.9	9.6	8.6	8.4	8.3	8.8	9.5	**9.3**	10.1
Bound Tests													
B1. Real GDP growth at historical average minus one standard deviation in 2006–07	7.5	7.8	7.6	7.8	8.3	8.8	7.8	7.6	7.6	7.7	8.1	**8.1**	7.0
B2. Export value growth at historical average minus one standard deviation in 2006–07 2/	7.5	7.8	8.7	9.9	10.9	11.4	10.1	9.8	9.9	10.0	10.8	**11.2**	9.3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006–07	7.5	7.8	7.6	7.8	8.3	8.8	7.8	7.6	7.6	7.7	8.1	**8.1**	7.0
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 3/	7.5	7.8	7.6	8.0	9.0	9.4	8.3	8.1	8.1	8.2	8.9	**9.4**	7.7
B5. Combination of B1-B4 using one-half standard deviation shocks	7.5	7.8	8.4	9.2	10.1	10.5	9.4	9.1	9.1	9.2	9.9	**10.2**	8.5
Debt service-to-revenues ratio													
Baseline	18.7	21.7	20.2	19.4	21.0	20.9	19.7	18.8	18.7	18.8	19.7	**19.4**	15.5
New public sector loans on less favorable terms in 2006–25 1/	18.7	21.7	20.2	19.9	22.3	22.9	21.9	20.7	20.5	21.6	23.1	**22.3**	22.6
Bound Tests													
B1. Real GDP growth at historical average minus one standard deviation in 2006–07	18.7	21.7	20.5	19.9	21.5	21.4	20.2	19.2	19.2	19.3	20.2	**19.9**	16.0
B2. Additional public borrowing of 6 percent of GDP in 2006–07	18.7	21.7	20.2	19.9	22.0	21.9	20.7	19.7	19.6	19.6	21.1	**21.7**	16.7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006–07	18.7	21.7	21.0	20.9	22.6	22.4	21.2	20.2	20.2	20.3	21.2	**20.9**	16.8
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 3/	18.7	21.7	20.2	20.0	22.5	22.3	21.1	20.0	19.9	20.0	21.6	**22.7**	17.2
B5. Combination of B1-B4 using one-half standard deviation shocks	18.7	21.7	21.7	22.4	24.7	24.5	23.1	22.0	22.0	22.0	23.5	**23.8**	18.6
NPV of debt-to-revenues ratio													
Baseline	495	475	443	426	394	377	357	352	340	329	318	**306**	224
New public sector loans on less favorable terms in 2006–25 1/	495	475	461	457	433	424	411	412	407	401	395	**389**	346
Bound Tests													
B1. Real GDP growth at historical average minus one standard deviation in 2006–07	495	475	451	436	403	387	367	362	350	340	328	**316**	228
B2. Additional public borrowing of 6 percent of GDP in 2006-07	495	475	465	476	439	421	399	392	380	368	354	**340**	235
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006–07	495	475	461	458	424	406	386	380	368	357	344	**332**	240
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006–07 3/	495	475	472	498	459	439	417	409	396	384	369	**354**	240
B5. Combination of B1-B4 using one-half standard deviation shocks	495	475	492	523	483	463	439	432	418	405	390	**375**	262

Source: Staff projections and simulations.
1/ 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.
2/ 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).
3/ Includes official and private transfers and FDI.

Table 5. Lao P.D.R. Projected Impact of the Multilateral Debt Relief Initiative (MDRI) 1/
(In millions of U.S. dollars, unless indicated otherwise)

	NPV of Debt			
	End-2006	Post-Traditional Debt Relief	Post-HIPC Initiative	Post-MDRI
Multilateral Debt	1,064	1,064	931	641
of which:				
ADB	536	536	469	469
IDA	399	399	349	66
IFAD	27	27	23	23
OPEC	14	14	12	12
NDF	31	31	27	27
IMF	32	32	28	22
EIB	26	26	23	23
Bilateral Debt	417	204	179	179
of which:				
Japan	66	48	42	42
Russia	319	126	110	110
Germany	4	1	1	1
Sweden	10	10	9	9
China	0	0	0	0
Thailand	17	17	15	15
Norway	0	0	0	0
France	1	1	1	1
Commercial Debt	127	127	111	111
Total external public debt	1,609	1,396	1,221	931
(in percent of exports) 2/	198	171	150	114
(in percent of revenue) 2/	440	382	334	255
(in percent of GDP) 2/	52	45	39	30
Memorandum Items:				
Projected Exports (average, 2004–06)	814			
Projected Revenue (end-2006)	366			
Projected GDP (end-2006)	3104			

1/ The calculations are approximate and are provided for illustrative purposes only. Assumptions: (i) Paris Club rescheduling is implemented on Naples terms with a cut-off date in June 1999; (ii) Decision point is reached in 2007; (iii) Completion point is reached in 2009. Uses end-2004 exchange and interest rates. Future disbursements and amortization are based on Fund staff projections. MDRI relief is based on end-2003 debt to IDA and end-2004 debt to IMF.

2/ Ratios are based on staff's projections of end-2006 numbers. Debt-to-export ratios use a three-year average exports.

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IMF Concludes 2005 Article IV Consultation with the Lao People's Democratic Republic

On March, 8, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Lao People's Democratic Republic.[1]

Background

The economy performed well during 2005. Economic growth increased to 7 percent, driven mainly by an expansion in activity at the Oxiana gold and copper mine and the construction of the Nam Theun 2 (NT2) hydro-electric dam. Higher rice and fuel prices put upward pressure on inflation in mid 2005, but core inflation remained at around 5-6 percent. With food prices easing, headline inflation fell back to 8.8 percent in December. The external position held up well, despite a number of adverse shocks. A surge in mining exports helped to offset the impact of higher oil prices and lower garment exports. Consequently, external reserves remained broadly unchanged, at around $230 million or 3 months of imports.

Macroeconomic policies remained on track, but the underlying situation continues to be fragile, especially in view of Lao P.D.R.'s high external public debt (80 percent of GDP). The government kept a tight control over the cash budget deficit (3.5 percent of GDP) despite shortfalls in revenue. However, with debt service and the wage bill continuing to rise, non-wage spending has come under increasing pressure. The Bank of the Lao P.D.R. maintained

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the March, 8, 2006 Executive Board discussion based on the staff report.

monetary stability, through tight control over its net domestic assets, but large directed credits at the state-owned commercial banks pose a risk to macroeconomic stability.

The economic outlook is favorable, provided progress is made on structural reforms. Growth should remain strong during the next few years (in the range of 6-7 percent), driven by the continuing stimulus from NT2 and the large mining projects. The external outlook is also reasonably buoyant as these projects should generate sizeable net inflows. However the prospects for sustaining a rapid pace of growth and development depend on actions to address key structural weaknesses—especially with regard to revenue mobilization, which is critical for progress towards debt sustainability, and reform of the state-owned commercial banks. Progress on both fronts continued to be slow in 2005. Further efforts will also be needed to advance trade reforms and improve the investment climate.

Lao P.D.R.'s PRGF arrangement, approved in April 2001, lapsed in April 2005, with only three of six reviews completed. Although macroeconomic performance remained broadly on track, lack of progress on structural reforms and safeguards policies prevented completion of further reviews. An Ex Post Assessment (EPA) of performance under Lao P.D.R.'s PRGF and ESAF programs has been completed. The EPA concluded that the design of the programs had been broadly appropriate, but that slippages with regard to key structural reform objectives suggested that, in addition to capacity constraints, there had been insufficient government ownership of the reforms.

Executive Board Assessment

Executive Directors commended the Lao P.D.R. authorities for maintaining stable macroeconomic conditions and welcomed the robust economic growth and the progress in reducing poverty. While disciplined economic management has underpinned the improved performance of the economy in recent years, Directors noted that many challenges remain. The underlying macroeconomic situation remains fragile, reflecting weaknesses in the fiscal position and the banking system, as well as the large external debt burden. There is also a need to improve the trade and investment regime to enhance the competitiveness of the economy, and expenditure management needs to be strengthened to ensure a more effective use of public resources for poverty reduction. Directors encouraged the authorities to use the opportunity provided by the sixth national development plan to move forward in these critical areas.

Lao P.D.R.'s economic outlook is favorable given the sizeable stimulus from major projects in the mining and hydropower sectors, but Directors stressed that this is not without risk. The immediate priority is to ensure a sound budget framework for 2005/06, based on realistic revenue targets and a sustainable expansion in the wage bill. In this context, Directors welcomed the authorities' commitment to make the expansion in civil service employment conditional on strengthened revenue mobilization. This would allow for alleviation of the compression in nonwage spending in priority sectors, while containing the overall deficit to a level consistent with available concessional donor financing.

Directors welcomed the authorities' intention to continue to gear monetary policy toward reducing inflation. They agreed that the Bank of the Lao P.D.R.'s net domestic assets should remain the main anchor of monetary policy, and that firm control of net domestic assets should be underpinned by prudent fiscal management. Directors noted that rapid credit expansion by state-owned commercial banks, reflecting large credits to a government-sponsored project, posed a risk to monetary stability. They welcomed the initial steps to rein in the exposure of these banks, but emphasized the need to strengthen the regulations on single borrower exposure and to limit the scope of regulatory forbearance in this area. The authorities should also move swiftly to find a strategic investor to place the project on a financially viable footing. Directors considered Lao P.D.R.'s exchange rate system, with intervention focused on smoothing transitory fluctuations, to be appropriate.

Directors stressed the importance of mobilizing revenue to enable Lao P.D.R. to meet its substantial expenditure needs within a sustainable fiscal framework. The main priority is to establish a strong tax and customs administration to raise revenues and support major tax policy reforms, including the introduction of a VAT. Progress on this front would depend importantly on reforms to strengthen central control over revenue operations in the provinces.

Directors urged the authorities to advance the Public Expenditure Management Strengthening Program. While the immediate focus on improving budget monitoring is appropriate, the main priority is to establish a strong national treasury with effective control over public finances. Given its decentralized structure, strengthening fiscal management will require a broader review of center-province relations to clarify the assignment of revenue and expenditure responsibilities and establish a clear and credible revenue-sharing framework.

Directors noted the government's decision not to avail itself of debt relief under the enhanced HIPC and Multilateral Debt Relief Initiatives. To lower the country's high external debt, they encouraged the authorities to maximize grant financing and maintain a high level of concessionality on new borrowing, in addition to strengthened domestic revenue mobilization.

Directors urged the authorities to expedite the restructuring of the financially weak state-owned commercial banks. They encouraged the government to seek private participation in the banks to facilitate their reform and enhance the banking system. In the interim, it will be important to maintain close oversight of the banks until their restructuring is complete. Directors also emphasized the importance of improving bank supervision, and urged the authorities to provide a more level playing field for private banks.

Directors encouraged the authorities to strengthen the trade and investment climate to improve the economy's competitiveness. They welcomed the authorities' plans to move ahead with the ASEAN Free Trade Agreement and their initiation of formal negotiations for WTO accession, and considered these as important steps towards integrating the economy into the regional and global markets. Directors were encouraged by the approval of a new Enterprise Law, but noted that more needs to be done to create a transparent and predictable regulatory environment for investors, and develop an effective legal and judicial system.

Directors welcomed the opportunity to review Lao P.D.R.'s performance under Fund arrangements since the early 1990s. They agreed that Lao P.D.R. had made significant progress in reducing poverty and moving towards a market based economy under the ESAF and PRGF-supported programs, but noted that many challenges remain. Looking ahead, Directors considered that, in addition to building capacity, a strong consensus within government on needed structural reforms, especially in the fiscal and banking areas, will be important. Evidence of progress on this front should be a precondition for any future Fund-supported program. In the meantime, Directors were of the view that surveillance, combined with well-targeted technical assistance, would be the most appropriate form of engagement.

Directors expressed concern that the poor quality of economic statistics is hampering effective surveillance and urged the authorities to strengthen the balance of payments, the national accounts, and government financial statistics, especially at the provincial level. They also encouraged the authorities to address weaknesses in the accounting systems at the Bank of the Lao P.D.R., which are hindering the effective monitoring of monetary and foreign exchange developments.

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

Table 1. Lao P.D.R.: Selected Economic and Financial Indicators, 2001-2006

Nominal GDP (2004): $2,451 million
Population (2004): 5.79 million 1/
GNI per capita (Atlas method, 2004): $390

	2001	2002	2003	2004	2005	2006
					Projection	
Real GDP growth (percentage change)	5.8	5.9	6.1	6.4	7.0	7.1
Inflation (annual percent change)						
Period average	7.8	10.6	15.5	10.5	7.2	6.8
End of period	7.5	15.2	12.6	8.7	8.8	5.0
Government budget (in percent of GDP) 2/ 3/	11.5	10.7	9.5	9.9	9.8	10.1
Revenue	13.2	13.1	10.9	11.0	10.9	11.6
of which: resource 4/	1.7	2.4	1.3	1.1	1.2	1.5
Grants	3.1	2.0	2.1	1.1	1.4	1.5
Expenditure	20.7	18.4	18.6	15.5	15.9	17.1
Overall balance (including grants)	-4.4	-3.3	-5.7	-3.4	-3.5	-4.0
Government debt	99.2	101.7	95.7	84.6	77.3	73.8
Money and Credit (annual percent change) 2/ 5/						
Reserve money	-19.3	19.4	23.7	30.9	7.2	12.0
Broad money	7.8	12.9	24.1	21.0	8.1	11.1
Bank credit to the economy	27.6	-5.2	5.4	10.1	27.9	13.8
Interest rates (end of period) 2/						
On three-month deposits	16	17	10-15	9-11	...	...
On short term loans	12-18	12-20	22-25	16	...	...
Balance of payments (in millions of U.S. dollars)						
Exports	362	370	450	500	659	749
Imports	650	633	694	977	1142	1239
Current account balance (including official transfers)	-146	-131	-174	-361	-464	-394
(in percent of GDP)	-8.3	-7.2	-8.1	-14.4	-16.4	-12.7
Gross official reserves (in millions of U.S. dollars)	134	196	214	227	229	250
(in months of prospective goods and services imports) 6/	2.4	3.0	3.7	3.4	3.0	3.0
(in percent of short-term debt)	352	419	305	274	156	168
External public debt 7/						
(in millions of U.S. dollars)	1,600	1,717	1,915	2,086	2,225	2,416
(in percent of GDP)	91	94	90	83	79	78
Net present value (in percent of exports)	...	...	205	199	171	166
External public debt service						
(in millions of U.S. dollars)	36	36	40	52	67	73
(in percent of exports)	6.8	6.7	6.7	7.5	7.8	7.6
(in percent of revenue, excluding grants)	15.5	15.3	17.3	18.7	21.7	20.2
Exchange rate						
Commercial bank rate (kip per dollar; end of period)	9,490	10,680	10,467	10,377	...	...
Nominal effective exchange rate 8/	95.7	83.3	73.1	71.2	...	...
Real effective exchange rate 8/	102.1	97.3	97.6	103.2	...	...
Memorandum item:						
Nominal GDP (in billions of Kip)	15,702	18,401	22,598	26,540	30,237	34,216

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

1/ Projected.
2/ Fiscal year basis (October to September).
3/ Numbers for 2005 are estimates and for 2006 are staff proposal.
4/ Royalties and taxes from timber, mining and hydro-power projects.
5/ Money and credit data are evaluated at current exchange rates.
6/ Excludes imports associated with NT2 and the large Oxiana and Pan Australian mining projects.
7/ Russian debt is based on a preliminary agreement between the Lao P.D.R. and Russian governments.
8/ Base Year 2000=100.

Statement by Hooi Eng Phang, Executive Director for Lao People's Democratic Republic and Khamphout Sitthilath, Advisor to Executive Director March 8, 2006

Introduction

The Laotian authorities would like to convey their appreciation to the staff for the constructive discussions on issues pertaining to the Laotian economy during the Article IV consultation. The authorities are in broad agreement with staff's analysis and policy recommendations regarding the main challenges facing the economy, and thank the staff for a comprehensive set of papers. The authorities also appreciate the excellent and timely technical assistance provided by the Fund on bank supervision and the seminar presented by the staff on the topic of central-province relations and fiscal reforms during the recent mission.

The Laotian economy achieved very robust overall growth during the fifth development plan (2001-2005), with GDP growth on average exceeding 6 percent per annum, accompanied by a stable exchange rate and comfortable levels of international reserves. These achievements have resulted from the maintenance of prudent macroeconomic policies and the implementation of structural reforms. Despite these positive outcomes, the Laotian authorities are well aware of major challenges ahead to sustain high rates of broad-based growth and eradicate poverty. As highlighted in the staff report, Lao PDR's "poverty remains high, as over 73 percent of the population live on less than $ 2 per day."

While recognizing the enormity of the task to reduce the poverty levels for such a wide segment of the population, the authorities note that one of the main causes of this high incidence is the legacy of heavy bombing during the Indochina war, with unexploded ordinances (UXO) still affecting half of the country's territory, as indicated in Box 1 of the IMF Country Report No. 05/8. Since the end of the war, these leftover bombs have continuously threatened the lives of the Lao people, causing widespread injury and death, thus naturally affecting the socio-economic development of the country. The authorities would like to express appreciation to the donor community for financial support aimed at accelerating UXO clearance as this is needed to help meet MDGs.

Recent Economic Developments

Real GDP growth in 2004/05 has been quite robust as in the previous year. The estimated 7.2 percent growth was attributable mainly to industrial production, construction, tourism and agriculture. The exchange rate has remained stable since 2002 and the spread between the bank and parallel market rates has been kept below 2 percent. Inflation accelerated in October 2005 to 9.4 percent, mostly stemming from supply-side factors, particularly increasing oil and rice prices. Stable world oil supply and a new harvest of rice gradually reduced inflation to 8.8 percent by the end of 2005.

As the staff indicated, Lao PDR's external position was stable in 2005 despite a number of adverse shocks. Rapid export growth, high world gold and copper prices and FDI inflows allowed gross official reserves to reach US$226 million by the end of 2005, equivalent to about 3 months of imports. However, strong growth in imports arising mainly from higher oil prices and capital goods associated with the construction of the NT2 dam and the mining sector kept the external current account deficit at 17 percent of GDP.

Outlook

Lao PDR's medium-term prospects are favorable, with expected growth rates of about 7-8 percent, led by manufacturing, tourism, agriculture, and construction. This is higher than the staff's medium-term projection of about 6-7 percent which does not take into account many pipeline projects that would have a large impact on future economic activity, revenues and exports. Since the end of 2005, an increasing number of foreign companies have shown interest in investing in the hydro-power sector in Lao PDR, in addition to the Nam Theun 2 project. In particular, the Xekaman 3 hydropower project ($273 million) is expected to export electricity to Vietnam starting 2009. This will be a joint venture with Vietnamese concerns and Electricité de Lao (EDL) with a 15 percent stake. The $800 million Nam Ngum 2 project is slated to export electricity to Thailand starting in late 2010. This project will be equally owned by the government of Laos and three Thai companies. In addition, the construction of the $600 million Nam Ngum 3 project, which will have a capacity of 460 MW, is scheduled to begin in 2008 and is expected to be able to generate power by 2013. This project will be equally owned by the Lao government, two Japanese companies and a Thai industrial utility developer.

My authorities also believe that even aside from these large projects, the underlying strength of the economy is greater than described by the staff, although there are of course many challenges. Large investment in roads and bridges and the decentralization policy have also promoted growth, albeit mainly in areas close to the fast growing neighboring countries. In the tourism sector, the National Tourism Administration is expecting more than a million visitors to Laos in 2006, generating huge revenues for the tourism sector. This will spawn the emergence and growth of small and medium scale enterprises which would support broad-based growth. The many rural development activities that were initiated in the fifth development plan should help the rural sector although this process may be slower to show results.

Fiscal Policy

On the fiscal front, the authorities agree with the staff that the main priority is to mobilize revenue through an improved tax and customs administration as well as by strengthening central government control over revenue administration and treasury operation in the provinces. This will take due regard of sequencing, especially the need to strengthen local administrative capacity and financial reporting and auditing. In this connection, as a first step, the authorities have passed the new Customs Law and established the regional customs offices under the authority of the National Customs Department.

As highlighted in the staff report, the preliminary fiscal outturn for 2004/05 indicates that the budget deficit declined to 3½ percent of GDP, the same level as in 2003/04, whilst revenue collections increased from 11 to 11.4 percent of GDP. For the 2005/06 budget, the authorities will implement the fiscal package approved by the National Assembly in October 2005, which targets revenue at 11.9 percent of GDP and expenditure at 20.1 percent of GDP.

The staff highlighted that the revenue target is overambitious and warned that the new revenue bonus scheme will erode revenue collection. Our authorities disagree and believe that the new revenue bonus scheme, at one percent of total taxes collected (0.5 percent for customs duties and 1.5 percent for other taxes) will be an important element to strengthen revenue performance. These funds go to the Tax and Customs Departments to pay for the cost of collecting revenue. In particular, this will give the local revenue offices a stronger incentive to administer the revenue system according to the law. Nevertheless, the authorities are keeping an open mind on this and if the actual outturn shows that the new revenue bonus scheme does not produce the expected positive results, the authorities are committed to strengthening other revenue reforms for the next fiscal year.

On the expenditure front, the authorities' focus will be on the health and education sectors along with road construction and institutional capacity building. In particular, the authorities have given priority to improved social services, particularly in terms of health and education for the rural areas, which lack teachers and nurses. In this connection, the authorities will be recruiting 8,000 employees to be deployed in the rural areas, with the commitment to cut back spending should the revenue outturn fall below target. The staff have pointed to the need to contain increases in the wage bill and the authorities agree with them. However, the authorities wish to clarify that the increase in the wage bill reflects the extra cost of the eight thousand to be deployed to the rural areas and not the basic salaries of civil servants.

Monetary and Exchange Rate Policy

The Bank of Lao PDR (BOL) has been successful in implementing its monetary policy framework to cap inflation at a single digit. In order to further reduce inflation, the monetary stance of the BOL will continue to remain firm. Tight control over the BOL's net domestic assets will continue to be the main anchor of monetary policy. Credit extended by the State commercial banks (SCBs) will continue to be restrained and limited to 12 percent in the year ending September 2006, compared to 14 percent growth for total commercial bank credit. The actual credit growth of SCBs will be based on a careful risk assessment under new appraisal procedures, especially for foreign currency loans. Under this cautious stance, broad money is expected to grow by 18 percent in the year ending September 2006. This will allow gross international reserves to further increase to $240 million (3 months of imports) by September 2006.

On exchange rate policy, a managed floating exchange rate system has served Lao PDR well. The exchange rate has remained stable since 2002 and the spread between the bank and parallel market rates has been kept below 2 percent. The stable exchange rate has allowed the BOL to continue a prudent easing of the monetary policy stance while maintaining reserves at a comfortable level. In this respect, the authorities' intervention in the foreign exchange market is aimed at smoothing transitory fluctuations in the exchange rate, and maintaining an adequate level of reserves.

Structural Reforms

On the structural front, the authorities recognize that strengthening structural reform efforts in all sectors, particularly in the state commercial banks, state owned enterprises (SOEs) and the trade sector, and undertaking reforms to improve the investment climate for the promotion of private sector driven growth will be key to promoting economic efficiency and competitiveness. And these are crucial for sustainable economic growth and poverty eradication. Toward this end, the authorities will focus their efforts on increasing tax collection, strengthening public expenditure management and fiscal transparency, implementation of an agricultural and rural development strategy, reduction in transaction costs for initiating business activity, a strengthened financial system and reform of the judicial sector.

The authorities broadly agree with the staff's overall assessment of Lao PDR's financial system. In this context, the government will continue to implement the banking sector reform program supported by the AsDB, the World Bank, and the European Union. The authorities will maintain the two international bank advisors and four assistant bank advisors in the SCBs. As the SCBs become stronger under the reform process, the government will seek a strategic investor for one of the two reformed SCBs by 2006. The authorities agree with the staff that on-site and off-site inspections and overall credit limits for the SCBs will be maintained and critical operational benchmarks will continue to be provided for these institutions. In this context, the authorities intend to proceed with the recapitalization of the SCBs in four tranches from 2006 to 2008, based on the performance of each bank with respect to its respective governance agreement.

With regard to the cement project, the authorities consider it to be essential to the economy's future. Based on their assessment, the project is a viable and bankable project and the authorities are exploring ways to increase equity in this project and to diversify its sources of financing. Recently, the authorities have received investment bids from countries eager to participate in the project, namely Canada, France and Switzerland, and the authorities are now engaged in the process of selecting the most appropriate investor.

External Debt

Although Lao PDR's level of external debt is high, our authorities are committed to bringing the debt to GDP ratio on a downward trend. The authorities have reaffirmed that they **do not intend** to seek debt relief under the enhanced HIPC Initiative. In particular, our authorities believe that the analysis in the staff report overstates the risks for servicing the debt accumulated since 1999. A substantial part of this debt was incurred to support the government's investment in the electricity sector as well as in other utilities and roads and bridges. Our authorities believe that this debt will directly add to the economy's capacity to service this debt. Although much of this debt was channeled through the government, it was onlent to enterprises, especially EDL, who will be responsible for servicing this debt from export earnings and user charges, and will contribute royalties and dividends to the government.

The Lao PDR authorities reiterate their continued commitment to sound macroeconomic management and the reform agenda, consistent with the sixth five-year plan (2006-2010) and the National Growth and Poverty Eradication Strategy (NGPES). The reform program seeks to raise Lao PDR from the rank of least-developed country by 2020 while the key policy goals for the sixth five-year plan (2006-2010) are robust growth, rural development, poverty reduction, low inflation, and improvement in fiscal and monetary management. Despite our authorities' view on the HIPC Initiative, they acknowledge the large challenge in attaining these objectives. For this reason, our authorities would welcome a shift to grant financing by the international financial institutions, especially for social sector, rural development, poverty reduction, environmental, and technical assistance projects.

Data Issue

Despite the recent improvements in statistical data, our authorities recognize that there is room for further improvement in many areas to ensure quality data is used for policy formulation and dissemination to the public. Therefore, they would welcome receiving assistance from the donor community to provide capacity enhancement in this area, including suitable training for local personnel and the development of necessary processes.

Ex Post Assessment

The authorities appreciate staff's efforts and broadly agree with the ex post assessment (EPA) provided by staff. The EPA confirms that the Fund-supported programs that Lao PDR engaged in over the last decade have been beneficial. Under the Fund-supported programs, balance of payments stability was restored, the government's GDP targets were met, and poverty was reduced. On the structural front, prices were liberalized, the trade and payments systems have gradually opened up, and the privatization of non-strategic state-owned enterprises (SOEs) has been largely completed. In particular, macroeconomic stability regained momentum under the PRGF arrangement during April 2001-April 2005. However, the EPA also highlighted that the implementation of fiscal and banking reforms has been slower than originally planned. Persevering with these reforms will be the focus of our authorities' efforts in the period ahead.

The findings of the EPA raised concerns about the authorities' ownership of the reforms under the PRGF. Our authorities are strongly committed to the reforms agreed under the PRGF and other IFI-supported programs. However, they believe that capacity constraints both at the provincial and local government levels, coupled with a desire to move ahead with reforms on many fronts, contributed significantly to the difficulties in the timely implementation of the many conditions agreed under the IFI-supported programs. In particular, during the period 2002-2005, the authorities were simultaneously implementing the PRGF, a Financial Management Adjustment Credit (FMAC) and Poverty Reduction Support Credit (PRSC) - which later became the Poverty Reduction Support Operation (PRSO) - financed by the World Bank, and a Banking Sector Restructuring Program Loan

(BSRPL), financed by the AsDB. Also, as more experience and input on the reforms were obtained, some modifications to the substance, sequencing, and timing were needed. Nevertheless, as evident in the progress reported on the revenue, public expenditure management, and banking reforms, our authorities are fully committed to achieving the objectives of these economic reforms. Looking forward, they agree that engagement with the Fund is currently best served through surveillance and technical assistance. Our authorities look forward to the support and understanding from the international community to assist in the continuation of the reform efforts in Lao PDR.

Conclusion

Our authorities highly value continued support from the international community, including the Fund. Despite the numerous difficulties of the past, our authorities have achieved significant economic success, not least of which is stabilizing the economy. They recognize that much remains to be done before the country can achieve its medium term poverty reduction goals. They are studying best practice approaches to adopting a VAT that is appropriate for the Laotian economy in order to improve revenue mobilization. Our authorities are encouraging the private sector to utilize the opportunity of the NTR with the US to foster trade and are taking some primary steps toward WTO accession. The authorities are firm in their intention to continue with prudent macroeconomic policies, liberalization of the economy and improvements in the business climate.

We are pleased to inform the Board that the Laotian authorities consent to the publication of the staff report for the 2005 Article IV consultation, and the accompanying documents, with necessary deletion of market sensitive information.