INTERNATIONAL MONETARY FUND

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LAO PEOPLE'S DEMOCRATIC REPUBLIC

February 2015

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; 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 2014 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** prepared by a staff team of the IMF for the Executive Board's consideration on January 14, 2015, following discussions that ended on October 28, 2014, 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 December 15, 2014.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- An **Informational Annex** prepared by the IMF.
- A **Staff Supplement** updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its January 14, 2015 consideration of the staff report that concluded the Article IV consultation with the Lao People's Democratic Republic.
- A **Statement by the Executive Director** for the Lao People's Democratic Republic

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

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INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

December 15, 2014

KEY ISSUES

Context. Growth is moderating and credit growth has declined, but significant vulnerabilities remain. International reserves are inadequate by several internationally comparable metrics, the exchange rate remains overvalued, credit risks are rising, and high public debt requires attention. The authorities place a high priority on strong growth with macroeconomic stability. Policy corrections initiated over the past year were broadly in line with Fund advice, but should be further strengthened.

Outlook and risks. A moderate further cooling down in economic activity is expected, but the external position will remain fragile. Fiscal expansion, a sharp regional growth slowdown, and deteriorating terms-of-trade and capital inflows are the key risks.

Fiscal policy. The fiscal deficit has declined in 2014, but on current policies, is set to rise going forward. Stronger revenue efforts and expenditure rationalization are necessary to ensure continued consolidation. The tax base should be broadened and administration improved, along with containing public wages, and rationalizing off-budget capital spending and unproductive current spending.

Monetary and exchange rate policy. Greater exchange rate flexibility is necessary to absorb external shocks and facilitate reserves buildup. Reducing excess liquidity will help contain inflation, prevent excessive credit growth, and support interbank market functioning.

Financial stability. Immediate foreign-currency liquidity risks have receded, but bank balance sheets have weakened. Recognizing NPLs, phasing out regulatory forbearance, strengthening sound lending practices and supervision, and recapitalizing state-owned banks will support macro-financial stability.

Long-term growth. Much progress has been made in recent years on product and labor market openness, and poverty reduction. Further trade integration will improve the business climate, and promote private investment and institutional reform. Upgrading health and education infrastructure will raise the growth potential and reduce inequality.

Approved By
Markus Rodlauer and Chris Lane

Discussions took place during October 16–28, 2014. The staff team consists of A. Ahuja (Head), A. Dizioli, A. Myrvoda (all APD), assisted by S. Kalra and N. Ha (Resident Representative Office). S. Creane, J. Gottschalk, T. Kanada, I. Nield, and K. Seetharaman (all TAOLAM) joined the technical meetings. Mr. Rodlauer (APD), Mr. Santoso, and Mr. Kharel (OED) participated in the concluding meetings. Ms. Sirihorachai and Ms. Deng assisted in this report's preparation.

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CONTEXT

1. **The economy has been moving toward a "soft landing," with the key priority now to strengthen the external position and preserve financial stability.** GDP growth is moderating from 8 percent in 2013, partly from fiscal tightening, and credit growth has abated from excessive levels. Inflation has declined. Significant gains in poverty reduction over the past decade have been preserved, though inequality has increased slightly (Box 1). However, external vulnerabilities remain a concern. The current account continues to be in large deficit and international reserves remain inadequate for precautionary needs. The economy is exposed to downside external shocks, notably a regional growth slowdown and a deterioration in terms-of-trade and capital inflows. Following years of rapid credit growth, bank balance sheets are showing signs of weakness, raising financial stability concerns. Public and publicly guaranteed debt has risen to a level that requires attention.

2. **The authorities have placed a high priority on strong growth with macroeconomic stability.** The government recognized that fiscal policy was sharply expansionary and procyclical in 2013, and started to tighten in 2014. The medium-term GDP growth target has been lowered to 7½ percent per annum, from 8 percent. Additional fiscal consolidation efforts, greater exchange rate flexibility, tighter monetary conditions, and prompt efforts to address banking sector vulnerabilities would support the authorities' agenda to entrench stability and put growth on a sustained, robust path. Accelerating compliance with WTO and ASEAN commitments would promote trade integration and private sector-led growth, especially in the nonresource sector.

3. **The change in policy direction was consistent with past Fund advice, but policies should be further strengthened to reduce vulnerabilities.** The authorities have made progress on priorities outlined in the last Article IV consultation. Fiscal consolidation has commenced, mainly through curbs on civil service compensation and capital spending cuts. Public investment cuts have limited the BOL's quasi-fiscal lending and lowered credit growth. Strict enforcement of regulation on banks' net open foreign exchange positions and the limits on foreign-currency lending has helped reduce foreign-currency liquidity risk at banks. However, excess kip liquidity in the banking system has risen; greater exchange rate flexibility, observed in the second half of 2013, has not resumed; the authorities remain convinced that, measured against their preferred metric, international reserves are more or less adequate; and policies to strengthen banking sector soundness could be accelerated, particularly in light of worsening conditions at state-owned and some private banks. IMF technical assistance (TA) has increased in the areas of revenue administration, monetary operations, banking supervision, and government finance and external sector statistics.

MACROECONOMIC DEVELOPMENTS, OUTLOOK, AND RISKS

4. **Growth is moderating, though still high, and inflation has declined.** Real GDP growth is projected at about 7½ percent in 2014, supported by external demand and foreign direct investment (FDI). With initial fiscal consolidation efforts underway, domestic activity has slowed, led

by construction. Mining production continues to weaken, the result of a moratorium on new mines and the decline in global metal prices. Imports data indicate that nondurable consumption and investment growth continues to moderate. Inflation has fallen to 3 percent (October 2014) from 6½ percent at end-2013, largely from food and fuel prices (Figure 1).

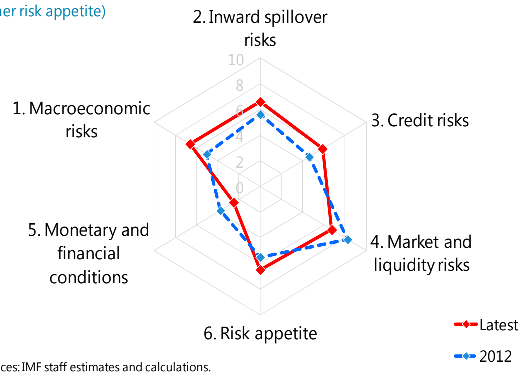
5. **Fiscal policy tightened in 2014.** The deficit declined to 4¼ percent of GDP in FY2014 from 5½ of GDP in FY2013, mainly from expenditure consolidation. Current spending (including arrears payment of ½ percent of GDP) was close to budget, thanks to efforts to contain the wage bill. Capital expenditure came in higher than planned, as the government paid down arrears by 1½ percent of GDP. Revenue collection rose by 15 percent (y/y), though tax revenues fell short of budget by about 2½ percentage points of GDP on account of weak mining profit tax collection and overly optimistic budgeted revenue. While still tight, the treasury's liquidity position has improved, with deposits covering 1½ months of current spending (Figure 2).

6. **While credit growth has declined, central bank balance sheet expansion continues to be brisk.** Cuts in public infrastructure projects have allowed credit growth to decline to 16 percent (y/y), from 35 percent (y/y) at end-2013. However, a sharp expansion in the BOL's net domestic assets has contributed to rapid reserve money and deposit growth. As a result, banks' excess reserves have risen to 7 percent of GDP, from 5 percent of GDP at end-2013, pressuring profitability and potentially leading to easier lending standards down the road (Figure 3).

7. **The external position remains highly vulnerable, and international reserves do not offer adequate protection against external shocks** (Box 2). The current account deficit is expected to remain large at 25 percent of GDP in 2014, with improvement in the nonresource current account balance, consequent of tighter fiscal policy and a pickup in export growth. Declining mining exports contribute to a slight worsening of the resource current account from last year. While FDI and long-term loan inflows are robust, particularly for export-oriented resource projects, the portion of the current account deficit financed by other, traditionally more volatile flows remains high at 7 percent of GDP (Table 2). The BOL has been intervening to keep the USD/kip exchange rate stable at slightly below the band's mid-point, resulting in an appreciation of 3½ percent (y/y) in nominal effective terms (Figure 4). The real effective exchange rate appreciated by 5 percent compared to a year ago, and the CGER-type analysis and broader trends in the balance of payments suggest that the kip remains overvalued by 10–20 percent relative to the level implied by medium-term fundamentals. Gross international reserves are estimated at 1 month of prospective imports of goods and services (US$0.7 billion, August 2014), a slight increase from 0.8 month of import cover during the last Article IV. External debt, mostly long-term, rose to 84½ percent of GDP in nominal terms (83½ percent of GDP in present value terms) from about 80 percent of GDP the previous year (76 percent of GDP in present value terms). Even though the risk of external debt distress remains moderate, it has increased compared to the last Article IV, verging on a transition to high risk (Debt Sustainability Analysis (DSA)).

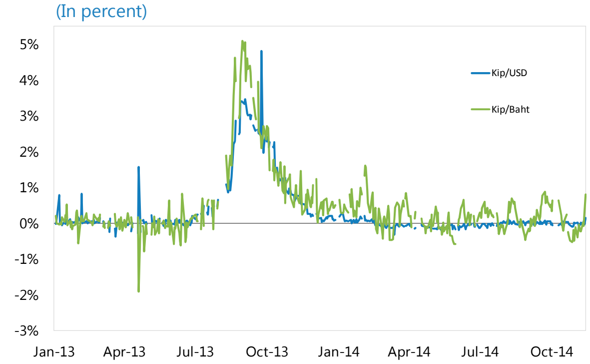
8. The implementation of recent policy measures has reduced immediate foreign-currency liquidity risks, but bank balance sheets have weakened in the past year (Financial Stability Map and Table 6). Limits on foreign-currency lending, supply of foreign exchange by the BOL and a leading state-owned bank, and robust foreign-currency deposit growth, have allowed banks to rebuild U.S. dollar liquidity buffers from very low levels. The USD/kip bid-ask spread has narrowed, and the previously sizable parallel foreign exchange premium has become negligible. Nevertheless, measured credit risks have risen. Accumulation of public infrastructure arrears has led to losses in the business sector, with knock-on effects on banks. The system's nonperforming loan ratio (NPL) is estimated to have doubled during the first half of 2014, cutting into bank profitability and capital cushion. In the same period, state-owned banks' average NPL is reported to have increased from 2 percent to about 8 percent, with average capital-to-asset ratio (CAR) declining to 3 percent. Reflecting partial dollarization in the economy (almost exclusively US dollar and Thai Baht), direct exposure to foreign currency through lending and deposits remain high, with the foreign-currency shares in total lending and deposits standing at 48 percent, down from 50 percent in 2013.

Lao P.D.R: Country Financial Stability Map
(Away from center signifies higher risks, easier monetary and financial conditions, or higher risk appetite)



Sources: IMF staff estimates and calculations.

Lao P.D.R.: Parallel exchange rate premium
(In percent)



Source: Bank of Lao P.D.R.

9. A moderate further cooling down in economic activity is expected in the near term, but external vulnerabilities will remain elevated. As growth continues to moderate, inflation is projected to remain in the mid-single digits. The current account deficit is projected to improve gradually to about 21 percent of GDP, but with lower capital inflows, reserves would rise only slightly to 1¼ months of imports by end-2015. Over the medium term, growth is projected to be close to the official target of 7½ percent in the baseline, supported by strong resource-related FDI, a gradual pickup of investment inflows into nonresource sectors, and accommodative monetary and fiscal policies. Long-term purchase agreements governing tariffs and volumes will help insulate power export income from fluctuations in energy prices, and as large-scale power projects come on line, lifting exports and moderating resource imports, the resource current account would turn into moderate surplus. However, with the overall current account weighed down by the large deficit in the nonresource sector and reserves projected at around 2 months of imports, the external position would remain fragile and a significant risk to sustained growth. A more robust and sustainable growth path would require medium-term fiscal consolidation, greater exchange rate flexibility, and tighter domestic monetary conditions, in line with staff's advice (Alternative scenario, Table 7).

10. Under the baseline, downside risks continue to dominate. A more expansionary fiscal stance would worsen the external position. With a very thin international reserves cushion, shocks that have been common in the past, such as terms-of-trade deterioration or a decline in capital inflows, could force large movements in the exchange rate. Such sudden and large exchange rate depreciation could lead to debt defaults, given high external debt, deteriorating net foreign asset positions at banks, and sizable domestic foreign-currency lending. This could precipitate a loss of confidence in the banking system, and trigger deposit flights. With an economic slowdown and bank recapitalization needs, public debt sustainability would be undermined (see DSA). A protracted growth slowdown in China, Thailand, and Vietnam would lower export growth, investment inflows, grants and remittances, as well as fiscal revenues (Figure 5).

Authorities' Views

11. The authorities shared staff's assessment that the economy was adjusting in the right direction. They broadly concurred with the near-term macroeconomic and financial sector outlook, and are concerned about weaker mineral export prices and potential capital flow volatility triggered by China's slowdown and tighter financial conditions in the United States, respectively. Nevertheless, the authorities considered international reserves to be adequate, based on their preferred metric, at close to the target of 5 months of official merchandise imports associated with non-FDI activities—a significantly lower amount than those used in the staff's metric based on trading partners' export statistics (Tables 2 and 5). In addition, they pointed out that the nonbank private sector was already highly dollarized, reducing the need for international reserves holding for precautionary reasons.

Lao P.D.R.: Risk Assessment Matrix

Risk	Up/Down-side	Likelihood	Impact	Transmission channels	Policy Response
Large, abrupt exchange rate depreciation, triggered by terms of trade deterioration (global metal price decline/sharp rise in oil prices) or decline in private capital inflows	↓	**M**	**H**	Loan repayment difficulties leading to defaults, loss of confidence in banks, deposit flight; heightened public debt distress; adverse macro-financial feedback loop.	Accelerate fiscal consolidation, and trade/investment reforms. Activate banking crisis management plan, ensure emergency liquidity while maintaining monetary control, orderly bank recapitalization and resolution, strengthen safety nets. Stand ready to raise interest rates. After the nominal exchange rate is stabilized, interest rates can be lowered, and fiscal policy adjusted to support the recovery.
More expansionary fiscal policy	↓	**L**	**H**	Worse external position. Monetary control and business confidence undermined	Broaden revenue base, reduce exemptions, strengthen administration, increase excise tax and VAT rate, curtail non-essential spending. Tighten domestic monetary conditions further.
Fiscal arrears clearance delayed	↓	**H**	**M/L**	Weaker business and bank balance sheets. Weaker private investment growth.	Announce clearance plan. Curtail current spending. Take necessary prudential measures to ensure robust banks' liquidity and solvency.
Protracted period of slower growth in advanced and emerging economies, growth slowdown and financial risks in China (medium-term)	↓	**H/M**	**M**	Weaker exports (especially mineral and electricity), tourism receipts, investment inflows, grants, and remittances	Adopt a monetary policy framework with greater exchange rate flexibility. Improve business climate, and accelerate capital market development to enhance productivity and attract FDI.

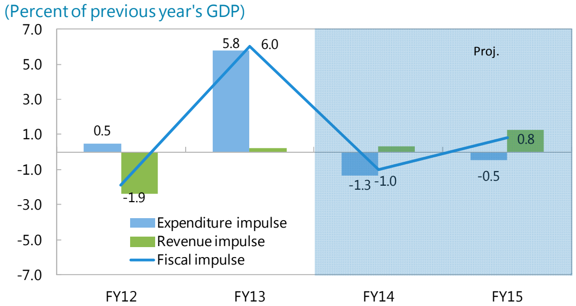
POLICY DISCUSSIONS

Discussion focused on continued fiscal consolidation, greater exchange rate flexibility, and tighter domestic monetary conditions to entrench macroeconomic stability, build international reserves, and address rising public debt; as well as measures to strengthen sound lending practices and crisis prevention to safeguard macro-financial resiliency. If implemented, this policy package would result in somewhat lower near-term growth than the baseline, but it would reduce near-term vulnerabilities and support robust, medium-term growth.

A. Fiscal Policy

12. Staff estimates that fiscal policy will ease slightly in FY2015 from weak mining revenue and a strong uptick in nonwage current spending. The deficit is projected to rise to 4¾ percent of GDP in FY2015 from 4¼ percent of GDP in FY2014, with the nonmining deficit largely unchanged at 6¼ percent of GDP. Revenue is budgeted to grow by 20 percent over the previous year's outturn, based on higher effective excise and value-added taxes on petroleum, luxury goods, and vehicles, stricter enforcement of customs rules, and other efforts to strengthen revenue administration and enhance compliance. Nevertheless, staff expects weak mining revenue to offset the gains from overall administrative efforts, resulting in an expansionary revenue stance. On the expenditure side, civil service compensation is budgeted to rise by 7 percent compared to last year's outturn to accommodate career promotion and a small net new intake, and capital spending would rise by 8 percent. While these efforts are expected to produce 1¾ percentage points of GDP in fiscal savings, a large budgeted increase in nonwage current spending would reduce fiscal savings by 1 percentage point of GDP, yielding a mildly contractionary expenditure stance.

Fiscal and Expenditure Impulses--Initial Contribution to Growth.
(Percent of previous year's GDP)



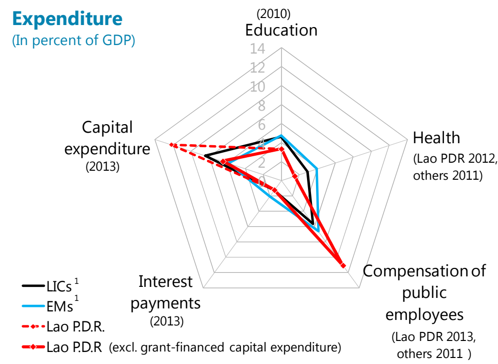
Sources: IMF staff estimates.

13. Unless revenue efforts are strengthened and expenditure rationalization intensifies, consolidation efforts would weaken over the medium term. The identification of remaining arrears is proceeding slowly, and plans to address them remain unclear. Staff's baseline fiscal projection assumes ½ percent of GDP in arrears payment in FY2015 and an additional 1½ percent of GDP over the medium term. On current policies, the deficits are expected to deteriorate beyond 5 percent of GDP in the medium term, with the nonmining deficit averaging at 7 percent of GDP.

14. Public and publicly guaranteed debt (excluding unidentified arrears) is projected at 60 percent of GDP in 2014 (52 percent of GDP in present value terms), requiring immediate attention. Longer-term public debt dynamics have worsened compared to the previous year, raising the risk of debt distress. Maintaining the current policy trajectory would increase public debt to about 65 percent of GDP in the medium term, making it infeasible under reasonable medium-term consolidation policies to achieve the authorities' target of 40–45 percent of GDP by the mid-2020s

(Table 5 and DSA). Moreover, mobilization of new capital for state-owned banks could potentially add to future public debt. Owing to significant reliance on external borrowing, public debt is also sensitive to large, abrupt exchange rate movements.

15. A more growth-friendly composition of expenditure is desirable over the medium term. Capital spending exceeds the low-income and emerging-market country averages. However, maintaining high-quality capital spending will become more challenging as grants are expected to decline as a percentage of GDP. More spending on education and health, currently low in a cross-country comparison, would improve long-term competitiveness and promote growth inclusiveness. Civil service reforms offer a potential to reduce compensation significantly as a share of GDP, increasing space for critical capital and social spending.



Sources: IMF, WEO; World Bank, WDI; World Health Organization; and IMF staff calculations.
[1] LICs amd EMs estimates based on samples of 57 and 96 economies, respectively.

16. Medium-term fiscal consolidation should be based on stronger revenue efforts and expenditure rationalization. A strategy anchored around a nonmining deficit target of no more than 5 percent of GDP would reduce near-term external vulnerabilities and lower public debt in the medium-term. On top of efforts to contain the public wage bill, more emphasis will be needed on revenue mobilization, controlling off-budget capital spending, and rationalizing non-essential current spending. To enhance fiscal credibility, the government should explain deviations from budget targets in the mid-term budget review to the National Assembly and outline corrective steps to get back on track.

17. Tax-base broadening and administration improvement have the potential to yield substantial additional revenues (Box 3). Proposed revenue measures include: (i) broadening the tax base by eliminating exemptions (mainly in CIT and VAT), flattening the PIT rate schedule; and introducing taxes on property value; and (ii) strengthening administration, notably by establishing a large taxpayer unit and increasing technical capacity to raise mining revenues, and raising the threshold at which VAT registration becomes compulsory. To help support medium-term revenue mobilization, it would be useful to undertake a comprehensive review of the tax system. Strengthening control over spending and cash resources (treasury single account (TSA)), revenue forecasts, and recording and processing of arrears would improve public sector financial management. A TSA would also facilitate BOL's liquidity management. These priority areas could be further developed in close cooperation with the IMF.

18. Expenditure strategy should focus on three elements: (i) containing the public wage bill in a sustainable way, including by accelerating civil-service reform; (ii) curtailing non-essential current spending; (iii) controlling off-budget capital spending and targeting capital expenditure to support the growth potential, in line with implementation capacity. The potential savings would provide scope for raising the shares of health and education spending in the budget, paying down arrears, and addressing possible contingent liabilities from state-owned bank recapitalization.

Authorities' Views

19. The authorities agreed with staff's fiscal assessment and recommendations, though successful implementation would require time to upgrade technology and staff capacity. More revenue efforts will be required to ensure continued consolidation, which is central to restoring macroeconomic stability. The government is undertaking investment to upgrade technology and staff capacity to strengthen tax administration. Significantly larger yields are expected from a focus on large taxpayers and taxes on vehicles, petrol, and luxury goods, as collection will be based on transaction prices instead of outdated reference prices. More use of electronic declaration and payments at customs check points, intensified efforts to counter smuggling, and electronic tax payments to enhance compliance are underway. Expenditure would be set based on more conservative revenue projections. The public sector wage bill would be contained through limits on new intake, and capital spending and off-budget expenditure rationalization remains a priority. A high-level committee has been established to quantify and resolve arrears and debts related to public infrastructure projects, and resolution could take several years. The National Assembly would welcome further fiscal transparency, and the authorities would welcome consultation with the Fund on expenditure rationalization experience in other countries.

B. Monetary and Exchange Rate Policy

20. The commitment to keep the exchange rate within a reasonably wide and adjustable band has provided an anchor for macro-financial stability, and merits staff's support. Making full use of this flexibility is important to help buffer external shocks. In addition, it will become increasingly risky to maintain a tightly managed peg to the U.S. dollar while the recovery in the United States firms up and the Fed exits from unconventional monetary support, given the overvalued real exchange rate, loose domestic monetary conditions, and the thin reserves cushion.

21. Greater exchange rate flexibility, tighter macroeconomic policies, and higher international reserves would bolster the exchange rate anchor. Staff recommends allowing the USD/kip exchange rate to move more flexibly within the official +/–5 percent band, with tighter fiscal and monetary policies supporting a gradual buildup of reserves to around 4 months of import cover. Occasional, modest intervention in the foreign exchange markets will be warranted to prevent rapid exchange rate movements and anchor expectations. This approach would help avoid the risk of a sharp, potentially destabilizing devaluation, particularly in light of the risks from currency mismatches.

22. Draining excess kip liquidity from the banking system will enhance the BOL's monetary and inflation control. Doing so would further limit the exchange rate pass-through to consumer prices, mitigating the risk of inflation resurgence as the exchange rate adjusts toward equilibrium (Box 4). Absorbing excess liquidity is also important for a functioning interbank market, and would enable the BOL to move toward targeting a short-term interbank rate in the medium term. Options include the resumption of BOL bill issuance, raising the reserve requirements on kip deposits, and accelerating the unwinding of quasi-fiscal lending. Ongoing collaboration between the BOL and IMF experts to develop the interbank market should help strengthen liquidity management and forecasting.

Authorities' Views

23. **The authorities agreed on the key objectives of low inflation and external stability, but were not convinced about the need for monetary tightening and greater exchange rate flexibility.** The BOL views inflation control as a priority, and notes from experience that movements in the kip vis-à-vis the U.S. dollar and the Thai baht could strongly influence domestic prices. While they agree that greater exchange rate flexibility would promote reserves accumulation, an outcome they desire, well-anchored exchange rate expectations are important to keep import cost and inflation in check and avoid capital outflows. The authorities are aware that tighter US monetary conditions could cause capital flow reversal and lower net inflows to Lao P.D.R., and are monitoring financial markets closely. They expect gross international reserves to rise in 2015 from government foreign-currency revenues sale and local governments' loan repayment to the BOL. Draining excess liquidity is not a near-term priority as credit growth is already declining, though more government bond issuance for liquidity management purposes could be considered in the future.

C. Financial Stability Issues

24. **Financial stability concerns are rising.** Despite lower credit growth, measured credit risks have increased as the corporate sector has become more leveraged over the past few years (Paragraph 8). Rising NPLs—reportedly concentrated in public infrastructure-related activity—have cut into bank profitability and capital cushion. Financial institutions have been granted forbearance on compliance with key prudential norms as they restructure delinquent loans. Looking ahead, growing excess liquidity gives banks scope to expand credit, potentially leading to easier lending standards in times of fewer investment opportunities and heightened near-term macroeconomic risks.

25. **Efforts to review asset quality at undercapitalized state-owned banks are welcome, but a more comprehensive agenda is needed.** Principal elements include: A more expeditious recognition of NPLs, supported by diagnostic assessments of systemic banks conducted by appropriate experts; ensuring that all banks achieve the minimum-mandated CAR of 8 percent in a prompt, time-bound manner after the diagnostic assessments have been performed; developing resolution options to deal with NPLs; strengthening financial supervision, with a timeline for phasing out regulatory forbearance. Staff encourages preparation of a contingency plan for the banking sector in the event of financial distress, including strengthening the institutional setup for crisis management with resolution authority, a sound emergency liquidity assistance framework with appropriate safeguards, a bank resolution framework, and a communications strategy. The IMF is ready to provide further TA on financial sector supervision, crisis management, and stress testing.

26. Putting in place key elements for sound lending practices would enhance macro-financial resiliency. This includes a clear and uniformly applied accounting framework, strong supervisory oversight and enforcement, a credit culture built on transparency, creditors' rights, independent and objective credit analysis, and an effective debt resolution process. International experience shows that moving in this direction would enhance the benefits from financial deepening and improve financial access by small and medium-sized enterprises (SMEs). Staff welcomes the recent approval of the AML/CFT law by the National Assembly and the authorities' commitment to implement all remaining items in the action plan as agreed with the Financial Action Task Force to ensure a robust operating environment for banks.

27. A number of measures have been taken to reduce exchange rate risks on bank and corporate balance sheets. These include strict enforcement of banks' compliance with the regulation on net open foreign exchange positions, the limits on foreign-currency lending to borrowers without sufficient foreign-currency income, and cash-on-hand requirements. Access to foreign-currency swap facilities with other central banks could mitigate the vulnerability of the banking system to foreign-currency liquidity shocks. Additional measures, such as maximum credit exposures in relation to capital, would help ensure sufficient loss absorption capacity. Collecting corporate and household balance sheet information and TA on assessing the balance sheet risks in the banking system would improve the BOL's ability to monitor and manage the economy's exposure to exchange rate risks.

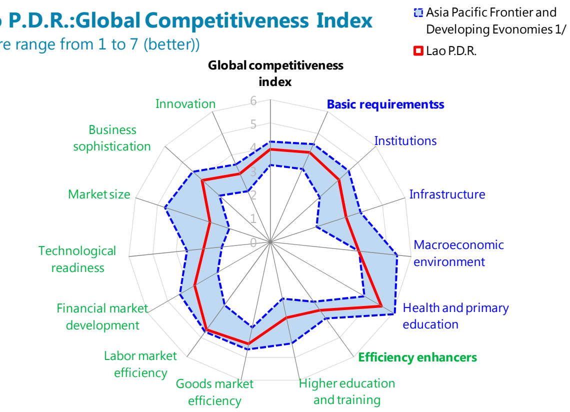
Authorities' Views

28. The authorities shared staff's assessment, and plan to move toward risk-based supervision in the medium term. The entry of foreign and private banks in recent years has expanded access to banking services, and helped create a more commercially oriented banking sector. The depth of the financial system has increased significantly, though financial access by SMEs remains limited. External auditing requirements and a depositor protection system have contributed to financial system stability. To ensure that supervisory and bank risk management capacity can keep pace with financial deepening, the authorities have suspended banking license issuance to review progress and address weakness. They emphasized strong regulatory enforcement to enhance credit quality and lower foreign exchange risks, and planned to build the framework and capacity for risk-based supervision. The BOL and the Ministry of Finance are coordinating to prioritize fiscal arrears settlement to limit new NPLs. Options to strengthen state-owned banks are under review.

D. Enhancing Competitiveness and Inclusive Growth

Lao P.D.R.:Global Competitiveness Index

(Score range from 1 to 7 (better))



Source: World Economic Forum, Global Competitiveness Report 2014-15.

1/ Range includes: Bangladesh, Bhutan, Cambodia, Mongolia, Myanmar, Nepal, Sri Lanka, Vietnam.

29. Lao P.D.R. ranks favorably among frontier and developing Asian countries under the overall competitiveness scale. This reflects, in particular, good progress made over many years in product and labor market openness, health, and education. (Global Competitiveness Map). While labor productivity is low compared to richer ASEAN neighbors, productivity growth is among the highest (Figure 6). Finance, real estate, business services, transport and communication, and construction are leading contributors to productivity improvement. Despite this progress, future productivity growth could be constrained by low vocational and tertiary education enrollment rates. Wage inequality is relatively low, and is partly accounted for by gender disparities and ethno-linguistic differences.

30. A steady focus on financial market development, education and training, statistics, and infrastructure upgrades would promote competitiveness and growth inclusiveness. Upgrading the quality, coverage, and publication of basic economic and financial data will improve the analysis of risks and policy formulation. Ongoing revisions to trade-related laws and regulations to meet WTO and ASEAN Economic Community (AEC) commitments would support international trade integration, improve the business climate, and promote private investment and institutional reform. An agenda could be developed to improve social safety nets for vulnerable workers, including those with less formal work arrangements. This would offer potential to make growth more productivity-driven, broader-based, and more inclusive.

Authorities' Views

31. There was broad agreement between the authorities and staff on policy priorities for longer-term growth. The authorities are making significant revisions to trade-related laws and the regulatory regime to promote trade integration under the WTO and AEC. Efforts are being made to enhance SMEs' financial access and promote private investment as a key growth driver. Public investment in health and education is expected to increase gradually, with priorities given to rural health clinics and vocational training to satisfy market demand. Decisions on public infrastructure investment are increasingly based on efficiency and social return. The authorities will continue to make use of IMF TA to upgrade national accounts, prices, government finance statistics, and balance of payments statistics.

STAFF APPRAISAL

32. **Lao P.D.R. has made progress in macroeconomic stabilization in the past year.** The fiscal deficit and credit growth have been reduced, and a measured cooling down in activity is expected in the near term. Inflation has eased, largely from food and fuel prices, and should remain in the mid-single digits barring major supply shocks. The immediate stress in foreign exchange funding has receded, thanks to measures to contain foreign-currency lending.

33. **Nevertheless, the external position remains fragile, and financial stability concerns have increased from last year.** International reserves remain inadequate by several internationally comparable metrics, and the real effective exchange rate is estimated to be overvalued by 10–20 percent. The large current account deficit and the tightly-managed, overvalued exchange rate are constraining reserves accumulation, leaving the exchange rate anchor vulnerable to shocks and negative macro-financial feedback. The economy is also vulnerable to spillovers from other external shocks, including a slowdown among regional trading partners. Public debt is rising to levels that could reduce fiscal space necessary for social and capital spending, and while the risk of external public debt distress is moderate, risks are increasing compared to last year. After a period of credit boom, signs of bank weakness are emerging, potentially constraining future growth and adding to public debt.

34. **Steady fiscal consolidation is necessary to reduce external vulnerabilities and put public finances on a sustainable footing.** A medium-term plan anchored around a nonmining deficit target of no more than 5 percent of GDP would help reduce the current account deficit and support international reserves buildup. Fiscal consolidation should be implemented in a manner that supports the growth potential. Raising revenue is central to this plan, achievable with a strategy to broaden the tax base and strengthen administration. Accelerating civil service reform would contain the public wage bill more effectively. Along with this, intensified efforts to curtail non-essential current outlays and off-budget capital spending would allow for faster arrears clearance and necessary social and capital spending to promote longer-term competitiveness and inclusive growth. Communicating this commitment clearly and further enhancing fiscal transparency will facilitate adjustment by other economic sectors and support future debt issuance.

35. **Greater exchange rate flexibility and tighter domestic monetary conditions will help strengthen international reserves and keep inflation in check.** Allowing the kip to move more flexibly within the official band, as the BOL did in the second half of 2013, will facilitate a gradual buildup of international reserves to four months of import cover. Tighter kip liquidity in the banking system, along with occasional, modest intervention in foreign exchange markets, will help prevent rapid exchange rate movements and anchor expectations. This approach is necessary to avoid a sharp, potentially destabilizing devaluation. Absorbing excess kip liquidity would further limit the exchange rate's influence on consumer prices, affording the BOL greater monetary and inflation control, and support interbank market functioning. Steps could also be taken to strengthen liquidity management and forecasting to support effective monetary policy implementation.

36. **A comprehensive approach to sound lending practices, banking sector supervision, and bank restructuring is critical to safeguard macro-financial resiliency.** Over-reliance on liquidity provision, forbearance, and unsafe lending practices charts a risky course that could lead to significant asset deterioration and an adverse feedback between financial and macroeconomic fragility. NPL loss recognition, supported by diagnostic assessments of systemic banks, would provide recapitalization cost estimates and restructuring options. Ensuring that all banks achieve the mandated minimum CAR, phasing out regulatory forbearance, and strengthening supervision would improve confidence and allocation of financial resources. Over time, an agenda based on adopting a clear and unified accounting framework, strengthening creditors' rights and rigorous credit analysis, financial transparency, and an effective debt resolution process would help enhance the benefits of financial deepening and financial access by SMEs. The IMF is ready to further assist the authorities in developing detailed plans to address supervisory weaknesses as well as a crisis contingency plan for the banking sector.

37. **Accelerating trade integration and increasing education and health spending would build on existing strength, and promote competitiveness and growth inclusiveness.** The authorities have achieved progress on product and labor market openness and made significant gains in poverty reduction. Further trade integration will improve the business climate, and promote private investment and institutional reform. Formal social safety nets for vulnerable workers and the marginalized rural poor and ethnic minorities would ensure that future growth benefits are better shared.

38. **More attention and resources need to be devoted to improving the quality and publication of basic economic and financial data.** Significant constraints are imposed on surveillance by weak data, inadequate reporting, and minimal progress has been made since the last Article IV consultation. Shortcomings are largely due to lack of capacity. The national account, government finance, monetary and financial sector, as well as external sector statistics are the key areas of deficiencies. A focus on these priority areas will help mitigate current vulnerabilities and improve overall public policies and services. Success will require a commitment to implement the Strategies for the Development of the National Statistical System, including through sustained dedication to capacity improvement and better coordination among agencies. The IMF stands ready to provide further TA to address specific needs, with active support from the technical assistance office in Bangkok and the recently established IMF office in Vientiane.

39. **It is recommended that the next Article IV Consultation takes place on the standard 12-month cycle.**

Box 1. Lao P.D.R.: Poverty Reduction, Inclusive Growth, and Challenges Ahead[1]

Lao P.D.R. has made significant progress in reducing poverty over the last two decades. The challenges ahead will involve tackling rural poverty and containing the rise in inequality.

The poverty rate, measured using a "basic needs" poverty line adjusted for inflation, was halved from 46 percent in the early 1990s to 23 percent in 2013, allowing Lao P.D.R. to achieve this MDG goal ahead of schedule. Significant steps have also been made toward increasing household asset ownership, improving living conditions, and expanding access to healthcare facilities, electricity, and other amenities. These efforts have contributed to a dramatic decline in maternal and child mortality rates as well as mortality from malaria and tuberculosis, and the country being on track to achieve gender parity in primary education (Table 8).

Nonetheless, a large fraction of households remain close to or below the poverty line and vulnerable to macroeconomic shocks. These households tend to be in the rural, northeastern and southern areas, isolated from main markets, belong to ethnic minority groups, and headed by persons with low education attainment. A large school enrollment gap also exists between children from poor and nonpoor households, indicating that poverty is persistent across generations. This education gap is particularly pronounced at the lower secondary level, with the net enrollment rate among poor children aged 11 to 15 years registering at 28 percent, compared to 57 percent among nonpoor children in 2013.

Over the years, remittances from migrant workers in large cities or neighboring countries have increasingly become an important source of economic support, and poverty rates are significantly lower among households receiving remittances. This success has brought some additional challenges, however. While remittances have facilitated consumption growth, uneven consumption growth patterns between the poor and the nonpoor households have contributed to a rise in inequality. The Gini coefficient was 36.2 in 2013, comparable to that of other countries in the region, rising marginally from 32.5 in 2003.

Based on cross-country experience, the following policy actions may facilitate further progress toward poverty reduction and serve to promote inclusive growth in Lao P.D.R.:

- Establishing a policy framework that ensures macroeconomic stability and reduces vulnerabilities to shocks.
- Supporting productivity growth, particularly in rural areas, through improvements in literacy and education, access to markets, health services and sanitation, and the investment climate. Targeting resources toward the rural poor and ethnic minorities would help address inequality of opportunities.
- Strengthen social sustainability through policies directed to inclusive growth and fair resource allocation, in particular, land.
- Providing employment opportunities to generate income-earning capacities for farmers, including by training, equipping, and educating them, in order to raise crop yields and conserve natural resources and the environment.
- Targeting the social spending and assistance for the vulnerable, and extending coverage beyond basic education and health services to enhance resilience to macroeconomic shocks.
- Improve data monitoring, data quality, and publication to ensure information accuracy and reliability.

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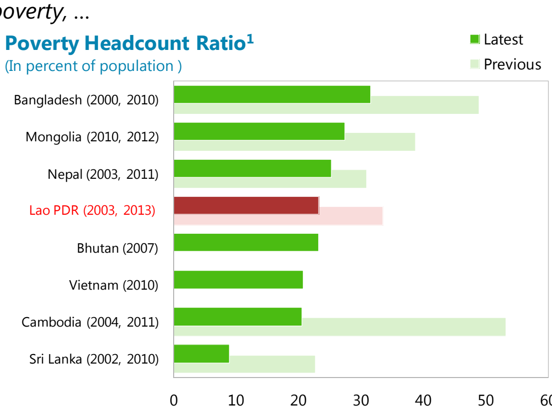
[1] Prepared by Alla Myrvoda. Based on 2012/13 provisional poverty estimates for Lao P.D.R., provided by the World Bank.

Box 1. Lao P.D.R.: Poverty Reduction, Inclusive Growth, and Challenges Ahead (concluded)

Poverty reduction outcome has been impressive, though inequality has also risen.

Significant progress has been made toward reducing poverty, …

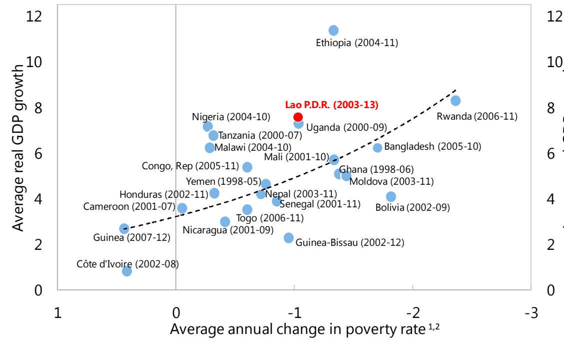
Poverty Headcount Ratio[1]
(In percent of population)



Sources: World Bank, WDI; National authorities; and IMF staff calculations.
[1] At national poverty line.

…prompted in part by favorable economic growth over the last decade.

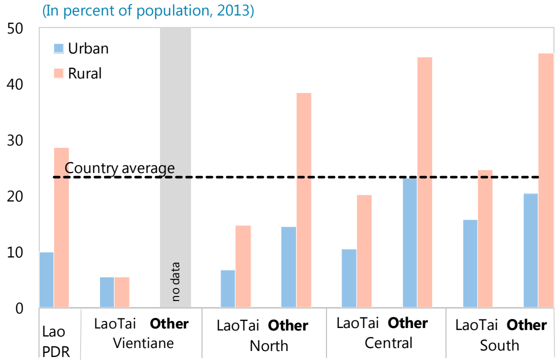
Average Poverty Reduction and GDP Growth
(In percentage points; low income countries)



Sources: World Bank, WDI; National authorities; and IMF staff calculations.
[1] At national poverty line. [2] Defined as average change in poverty rate during the specified period.

Poverty is substantially higher in rural areas and among ethnic minorities.

Lao PDR: Poverty Headcount Ratio: by Ethnicity[1]
(In percent of population, 2013)

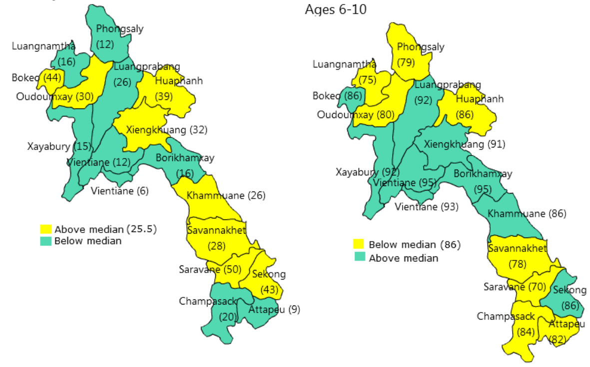


Sources: World Bank, WDI; National authorities; and IMF staff calculations.
[1] At national poverty line.

Poor households—concentrated more in the northeast and the south— tend to have lower school enrollment rates.

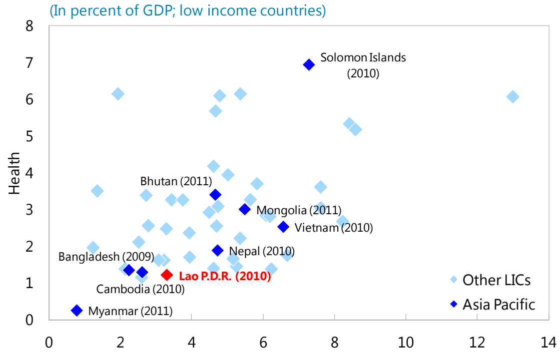
Poverty Headcount Ratio (2013)

Lao P.D.R.: Net Enrollment Rates (2013)
Ages 6-10



Public education and health spending is on the low side, compared to other LICs.

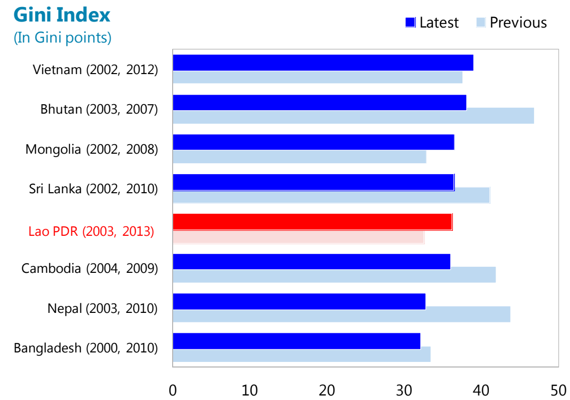
Public Expenditure on Health and Education
(In percent of GDP; low income countries)



Sources: World Bank, WDI; and IMF staff calculations.

Income inequality has increased during the last decade, primarily driven by rising disparity in urban areas.

Gini Index
(In Gini points)



Sources: World Bank, WDI; National authorities; and IMF staff calculations.

Box 2. Lao P.D.R.: External Sector Assessment[1]

The external position is highly vulnerable, and requires strengthening. The real effective exchange rate is estimated to be overvalued by 10–20 percent, and reserves are inadequate for precautionary needs.

Exchange Rate Assessment

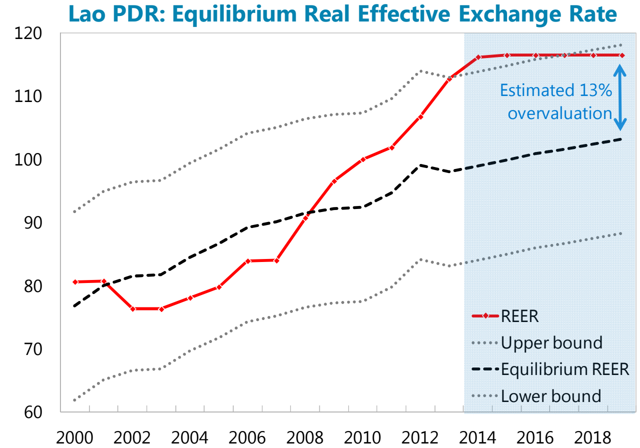
	Macroeconomic Balance	External Sustainability[1]	Equilibrium REER approach
Underlying current account balance (CA)	-16.4	-16.4	...
Current account norm	-8.5	-9.0	...
Required improvements in CA	7.9	7.4	...
Implied over(+)/under(-) valuation	19.6	17.9	12.9

Source: IMF staff estimates.
1/ NFA norm of -86 percent of GDP.

CGER-type analysis based on the macro-balance and external sustainability approaches suggests that the kip is overvalued by about 18–20 percent in real effective terms. The equilibrium real exchange rate approach indicates an overvaluation of 13 percent, following the large real effective appreciation registered in 2008–13. The estimates are subject to uncertainty which can be large, given weak data and a relatively high degree of dollarization.

Broader trends in the balance of payments also point to overvaluation. External competitiveness has been eroded from persistent, high labor cost growth during 2009–13 (upward of 20 percent per year). Despite the robust level of foreign capital inflows, dominated by FDI in the hydropower projects, private non-FDI flows are estimated to have declined in 2013. The core balance of payments—the portion of the current account not financed by FDI or official development assistance—is estimated to be in deficit at 10 percent of GDP, a slight improvement from 13 percent of GDP in 2012.

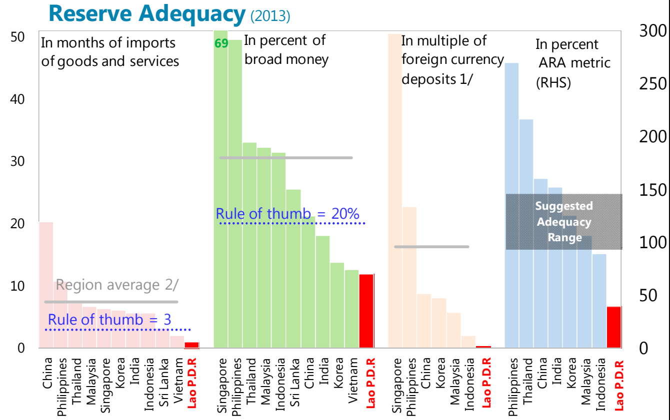
Lao PDR: Equilibrium Real Effective Exchange Rate



Sources: IMF staff estimates.

Measured against several metrics, Lao P.D.R.'s gross international reserves are well below regional comparator countries, and do not offer adequate protection against external shocks. In August 2014, reserves were equivalent to about 1 month of prospective imports of goods and services, 12 percent of broad money, and about 28 percent of foreign-currency deposits, all well below the levels desirable for countries with a fixed exchange rate regime and highly dollarized financial sector, according to the Fund's reserve adequacy metric.

Reserve Adequacy (2013)



Sources: IMF staff calculations.
1/Commercial banks' deposits. Bank deposits of nonbank customers for Singapore. Commercial and rural banks for Indonesia.
2/ Excluding Lao P.D.R.

Staff's overall assessment is that the external position is highly vulnerable and requires strengthening. Fiscal consolidation, tighter domestic monetary conditions, a more flexible exchange rate, and higher reserves would reduce near-term vulnerabilities. Over time, structural reforms to improve productivity, particularly in the nonresource sector, will be needed to bolster external competitiveness.

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[1] Prepared by Alla Myrvoda.

Box 3. Lao P.D.R.: Measuring the Exchange Rate Pass-Through to Inflation[1]

The influence of exchange rate movements on domestic inflation in Lao P.D.R. is limited and comparable to other countries in the region.

Monetary policymakers in small open economies pay attention to the impact on domestic inflation from exchange rate movements. This box investigates the extent to which domestic inflation in Lao P.D.R. is affected by changes in the exchange rate over the operational horizon of monetary policy (eight quarters), and how the measured pass-through compares with selected regional economies.

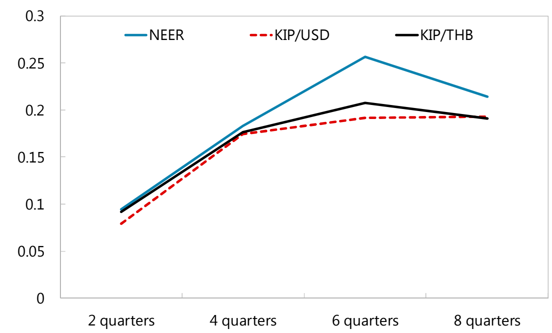
A Bayesian Vector Autoregression model (BVAR) was estimated using quarterly data over 2000–13, controlling for changes in producers' marginal cost through international commodity, fuel, and food prices. The BVAR is used to mitigate small sample and endogeneity problems in exchange rate pass-through estimation.[2] Estimated coefficients were significantly lower than those estimated using ordinary least square (OLS), indicating the presence of endogeneity.

- Exchange rate pass-through in Lao P.D.R. is partial and limited. The inflation response from 1 percent depreciation is less than one-tenth of a percent over the first two quarters. The pass-through elasticity peaks in the sixth quarter, after which it declines. The bilateral USD/kip and THB/kip exchange rates have similar pass-through over time.

- The pass-through elasticity in Lao P.D.R. is in line with regional comparators, ranging from 0.15 in Indonesia to around 0.3 in the Philippines. Lao P.D.R.'s median pass-through was about 0.2, but the margin of error in estimation is also high.[3]

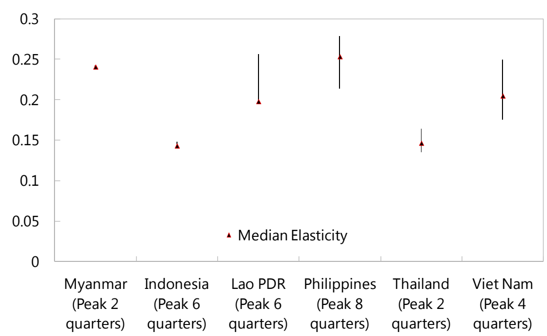
- The dynamics of the inflation adjustment vary across countries. Inflation response in Myanmar and Thailand is swift, declining after just two quarters, whereas for other countries, the inflation response can take two years to reach full impact, for instance in the Philippines.

Pass-through in Lao P.D.R.
(In percent)



Source: IMF staff calculation.

Cross-Country NEER Pass-Through



Source: IMF staff calculation.

[1] Prepared by Allan Dizioli.

[2] Campa and Goldberg (2002) discuss how the pass-through rates are endogenous to several macroeconomic conditions in a country and how OLS estimation might overestimate the impact of pass-throughs.

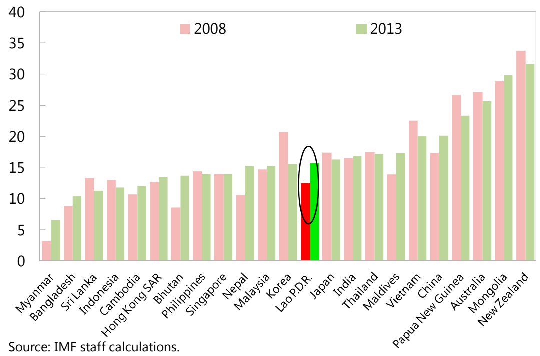
[3] The length of the lines measures the variability of the calculated coefficients when estimated using the different control variables.

Box 4. Lao P.D.R.: Tax System Productivity[1]

Room for tax productivity improvement and revenue collection is substantial—up to twice or three times today's levels—in corporate income tax (CIT), personal income tax (PIT) and the value-added tax (VAT).

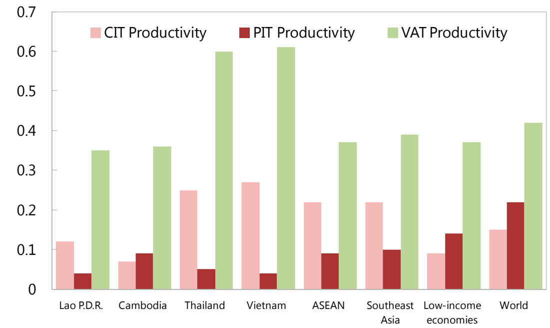
A productive tax system can raise substantial revenue through a broad tax base, allowing tax rates and compliance costs to be kept low. This box provides a high-level profile of the structure and performance of Lao P.D.R.'s tax system compared to regional peers, benchmarking the tax structure and revenue performance of three major taxes: CIT, PIT, and VAT.[2]

Figure 1. Revenue Performance in Asia
(In percent of GDP)



Source: IMF staff calculations.

Figure 2. Revenue Productivity of Different Taxes
(In percent of GDP)



Source: IMF's Fiscal Affairs Department revenue performance database.

Lao P.D.R.'s tax revenue effort compared well with the LIC[3] average at about 15½ percent of GDP in 2012, but underperformed when viewed against the regional[4] and world averages of 17 percent and 19 percent, respectively.

Key findings: At 35 percent, the CIT rate is higher than the LIC average (29 percent), the neighboring countries (24 percent), and the world average (24 percent). Notwithstanding this high rate, CIT collection comes in at the LIC average of 2½ percent of GDP, faring worse than regional and the world averages (5¾ and 3⅓ percent of GDP, respectively). At Vietnam's CIT productivity level, Lao P.D.R.'s CIT collection would almost triple, *ceteris paribus.*

PIT productivity is well below regional average, partly due to excessive segmentation of the tax rate schedule. The lack of a dedicated office to deal with large taxpayers hampers compliance work. PIT collection would almost double if productivity reached the average levels observed in the region, *ceteris paribus*.

With a similar VAT rate as regional peers, revenue collection is substantially poorer due to a low tax registration base and widespread use of exemptions and zero ratings. At Vietnam's productivity levels, Lao P.D.R.'s VAT collection would almost double, *ceteris paribus.*

[1] Prepared by Allan Dizioli.

[2] All structure and performance benchmarking data are from FY 2012–13 and are sourced from the USAID Collecting Taxes Database (http://egateg.usaid.gov/collecting-taxes).

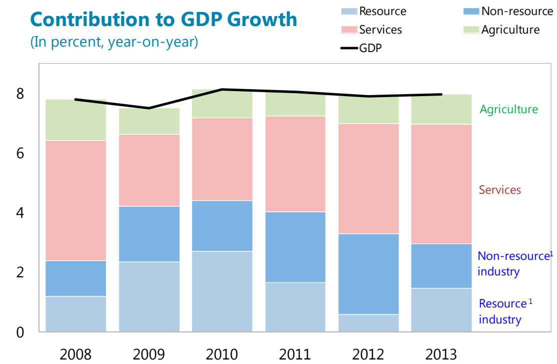
[3] Countries with GNI per capita of less than $1,215 are classified as low-income countries.

[4] Regional comparators include Brunei, Cambodia, Indonesia, Malaysia, Myanmar, Philippines, Singapore, Thailand, Timor-Leste and Vietnam.

Figure 1. Growth is moderating. Inflation is well contained.

Real GDP growth was about 8 percent in 2013, with strong impetus from services. Manufacturing and construction weakened, …

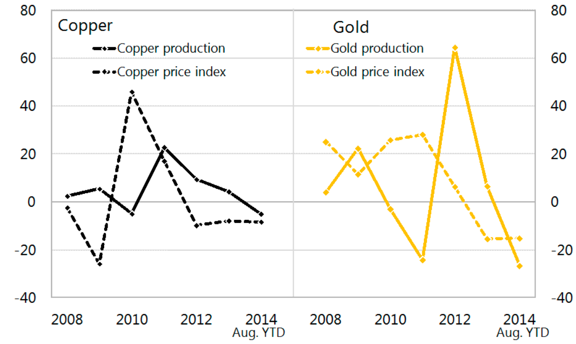
Contribution to GDP Growth
(In percent, year-on-year)



Sources: National authorities; and IMF staff calculations.
[1] Resource industries include mining and quarrying, electricity, water, and gas; non-resource indutries include manufacturing and construction.

…along with mining production—the latter the result of a moratorium on new mines and metal price decline.

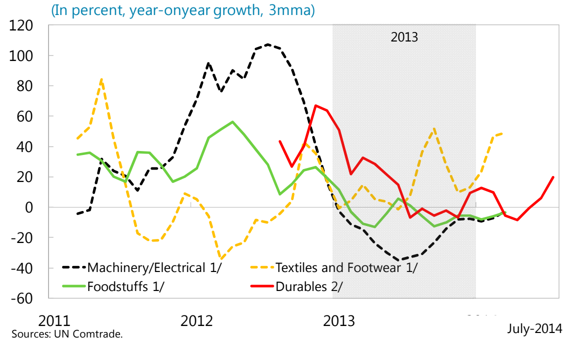
Mining Production
(In percent, year-on-year)



Sources: Bloomberg; IMF, CPS, and staff calculations.

Imports data indicate investment and consumption activity tapered off in 2013.

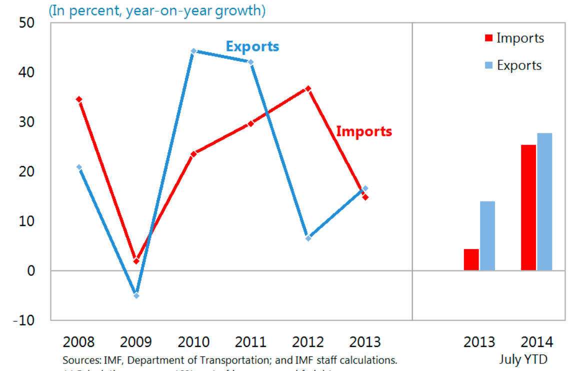
Lao PDR: Imports
(In percent, year-onyear growth, 3mma)



Sources: UN Comtrade.
1/Includes exports to Lao PDR as reported by Thailand, Malaysia, France, Italy, Australia, Germany, Netherlands, India, United States, and Spain.
2/Exports of durables from Thailand to Lao PDR.

An export rebound appears to be underway, led by China's demand.

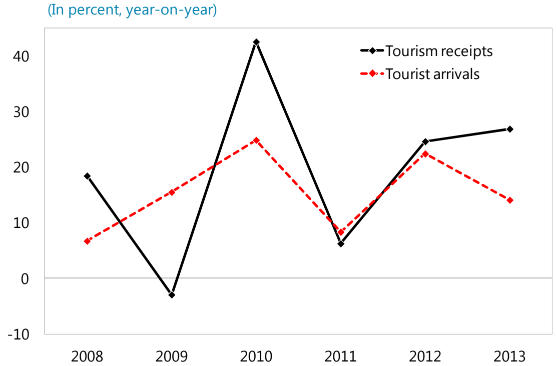
Merchandise Exports and Imports
(In percent, year-on-year growth)



Sources: IMF, Department of Transportation; and IMF staff calculations.
1/ Calculations assume 10% cost of insurance and freight.

Tourism activity continued to expand well.

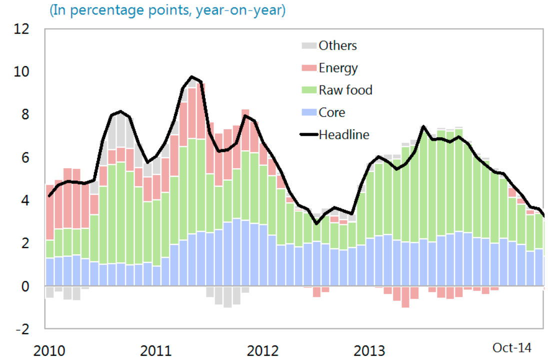
Tourist Arrivals and Revenue
(In percent, year-on-year)



Sources: National authorities; and IMF staff calcualtions.

Headline inflation is on a downward trajectory. Core inflation remains moderate and stable.

Contribution to Headline Inflation[1]
(In percentage points, year-on-year)

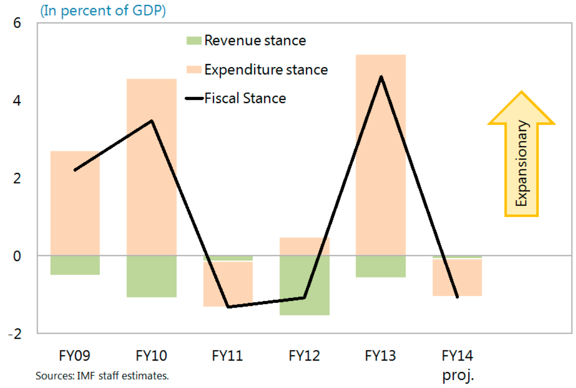


Sources: National Authorities; and IMF staff calculations.

Figure 2. Fiscal consolidation started.

The FY14 fiscal stance is moderately contractionary, a reversal to the previous year's sharp expansion.

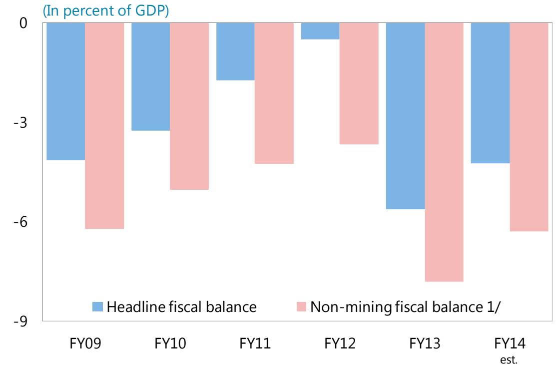
Fiscal Stance
(In percent of GDP)



Sources: IMF staff estimates.

The fiscal deficit narrowed in FY14.

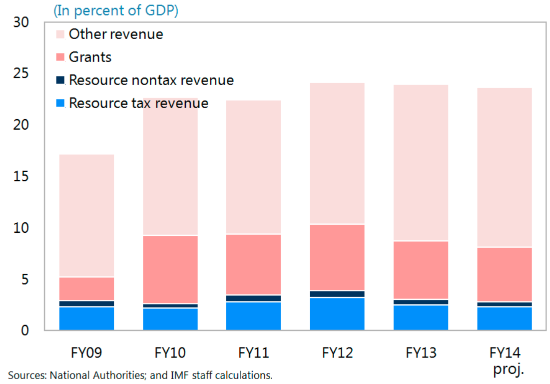
Fiscal Balance
(In percent of GDP)



1/ Net lending/borrowing minus mining revenues.

Overall revenue performance was relatively strong despite weaker mining revenue.

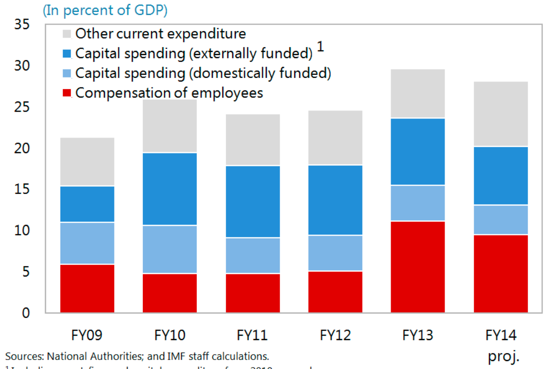
Revenue
(In percent of GDP)



Sources: National Authorities; and IMF staff calculations.

Expenditures are being contained,...

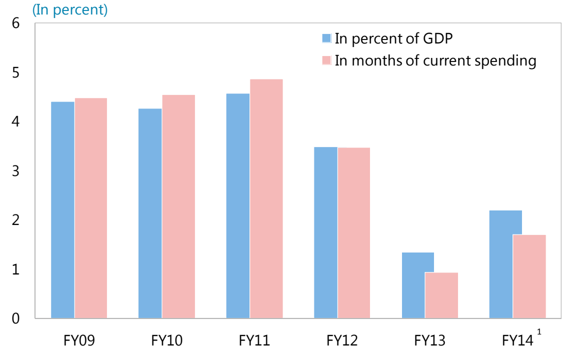
Expenditure
(In percent of GDP)



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

...which help shore up the government's liquidity position.

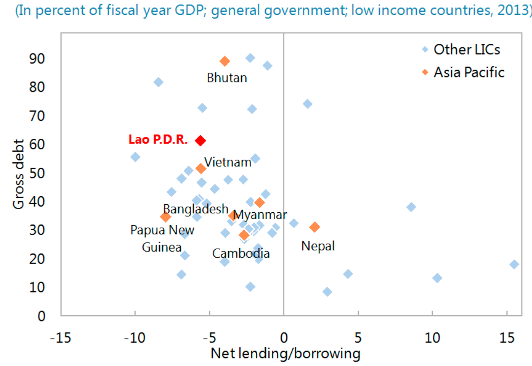
Government Deposits
(In percent)



Sources: National authorities; and IMF staff calculations.
1 Stock of government deposits as of August 2014, projected current spending and GDP.

Further consolidation is needed to rebuild fiscal space.

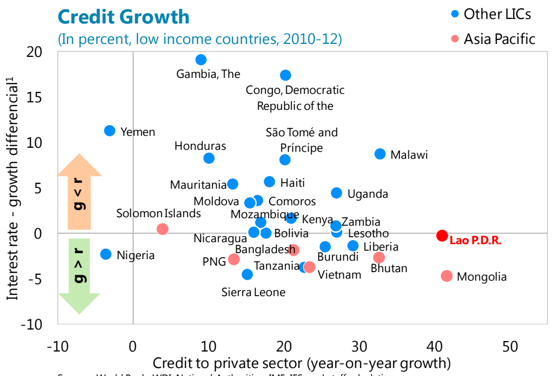
Fiscal Space
(In percent of fiscal year GDP; general government; low income countries, 2013)



Sources: IMF, WEO; and IMF staff calculations.

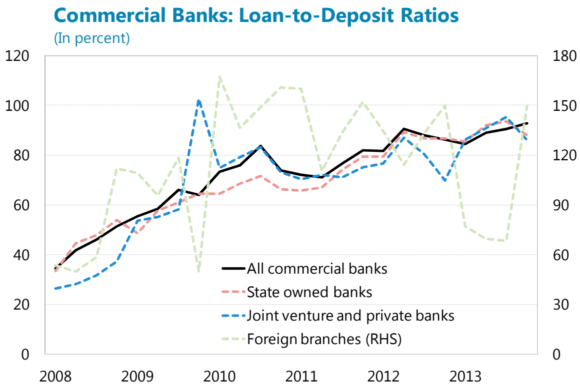
Figure 3. Monetary conditions remain accommodative.

Domestic financial conditions were highly accommodative after the global financial crisis.



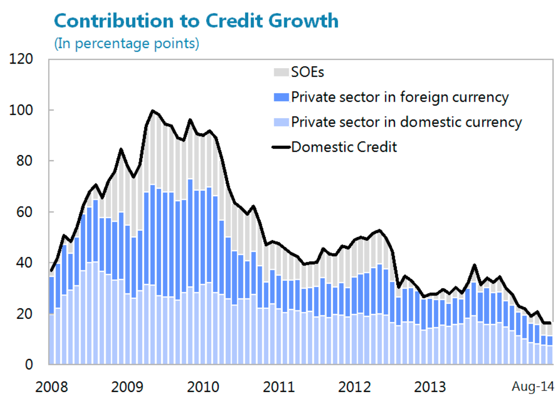
Sources: World Bank, WDI; National Authorities; IMF, IFS, and staff calculations.
[1] Lending rate deflated by CPI inflation.
[2] LAK 1-3 year landing rate for Lao PDR.

Banks' risk appetite pushes up loans against the deposit base.



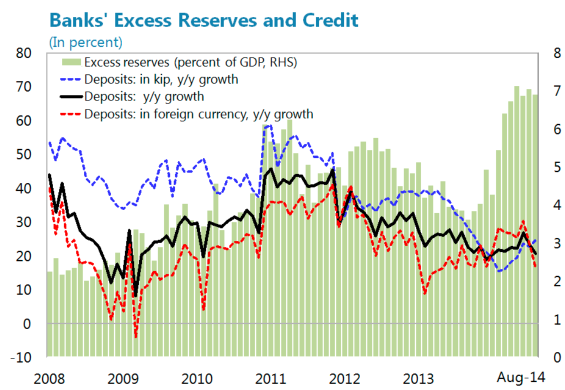
Sources: CEIC; and IMF staff calculations.

Credit growth has recently declined, thanks partly to restraints on public investment.



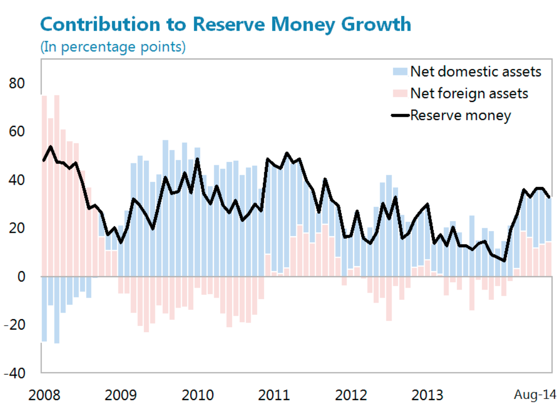
Sources: National Authorities; and IMF staff calculations.

But, as funding remains strong, excess liquidity is rising,...



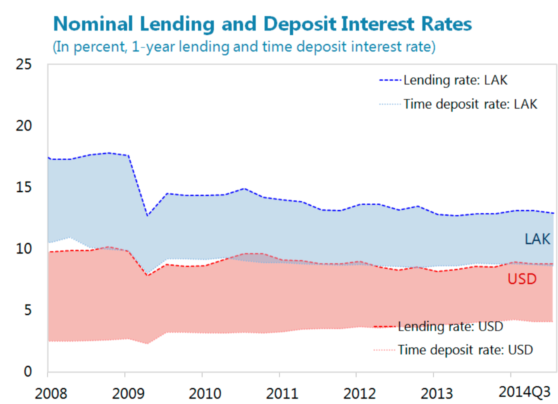
Sources: National authorities; and IMF staff calculations.

...given a sharp rebound in reserve money growth.



Sources: National Authorities; and IMF staff calculations.

Nominal interest rates have been more or less stable.

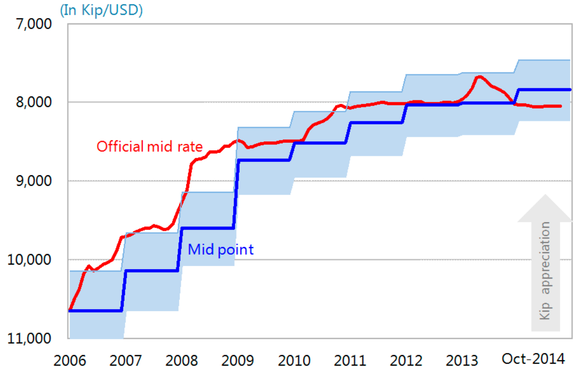


Sources: CEIC; and IMF staff calculations.

Figure 4. External vulnerabilities are elevated.

The USD/kip exchange rate has been stable within the band since early-2014.

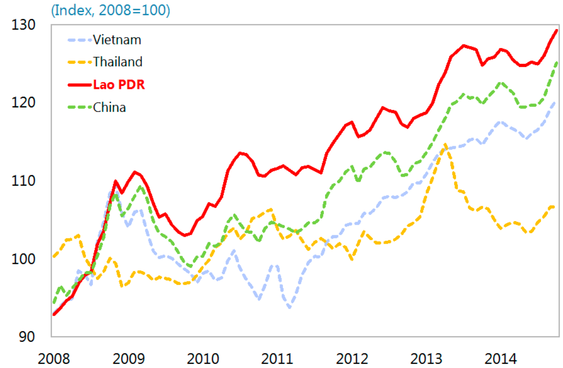
Exchange Rate
(In Kip/USD)



Sources: National Authorities; and IMF staff calculations.

The real exchange rate continues to appreciate.

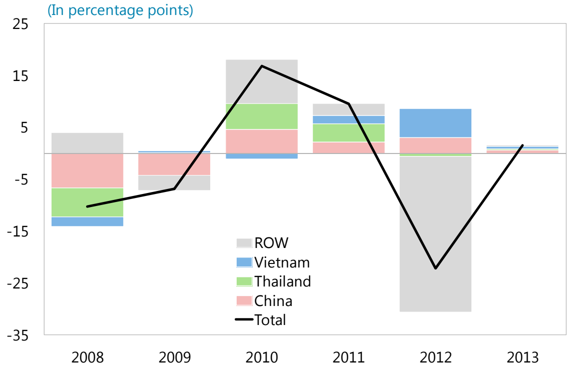
Real Effective Exchange Rate
(Index, 2008=100)



Sources: Bloomber; IMF, Information Notice System, National Authorities; and IMF staff calculations.

Export competitiveness—particularly the ability to penetrate new markets—has weakened.

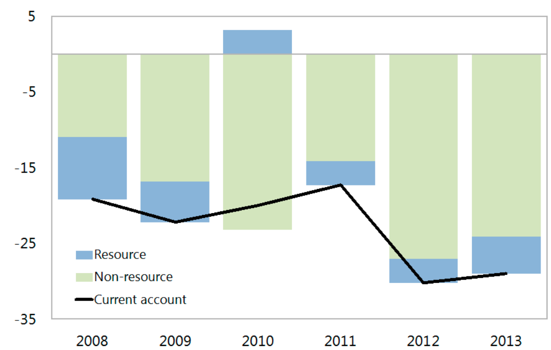
Contributions to Market Share Gains
(In percentage points)



Sources: IMF, Direction of Trade Statistics; and IMF staff calculations.

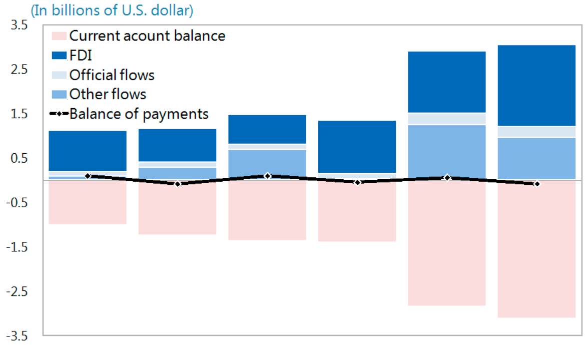
Nevertheless, slower import growth helped improve the nonresource current account position in 2013.

Current Account Balance
(In percent of GDP)



FDI expanded vigorously while non-FDI private flows ebbed somewhat.

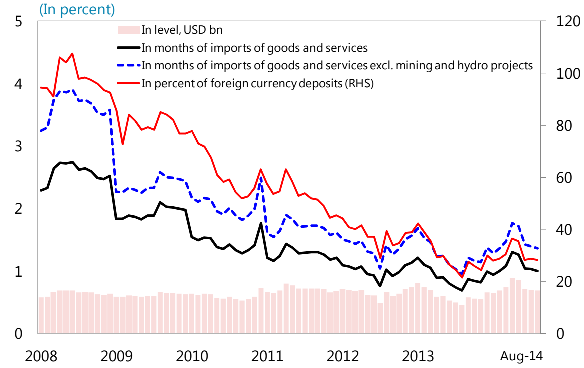
Balance of Payments
(In billions of U.S. dollar)



Sources: IMF staff calculations.

International reserves increased slightly from mid-2013 to around 1 month of imports.

Gross Official Reserves
(In percent)

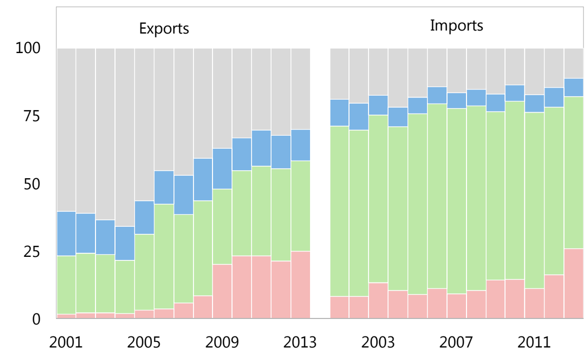


Sources: National Authorities; and IMF staff calculations.

Figure 5. External Linkages

International trade is increasingly concentrated to three regional partners: Thailand, China, and Vietnam

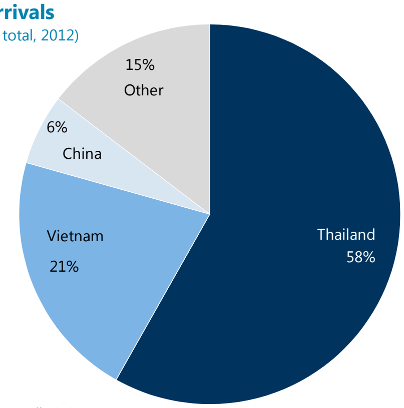
Trade by Country
(In percent, share of total)



Sources: IMF, Direction of Trade Statistics; and IMF staff calculations.

Tourism follows a similar pattern.

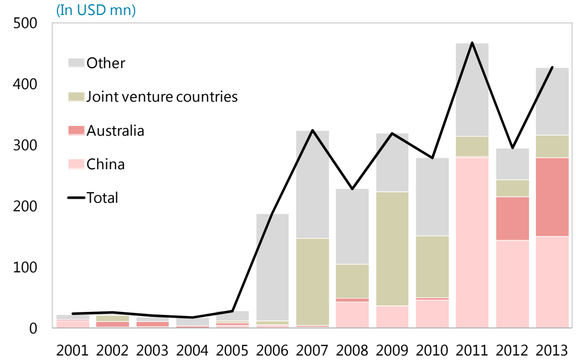
Tourist Arrivals
(In percent of total, 2012)



Sources: CEIC; and IMF staff calculations.

China and Australia have become prominent sources of FDI.

FDI: Funds Transferred Through Banking System
(In USD mn)



Sources: CEIC; and IMF staff calculations.

Foreign banks account for about a fifth of total commercial bank assets and a tenth of deposits.

Commercial Banks: Assets and Deposits
(In percent, by bank type)

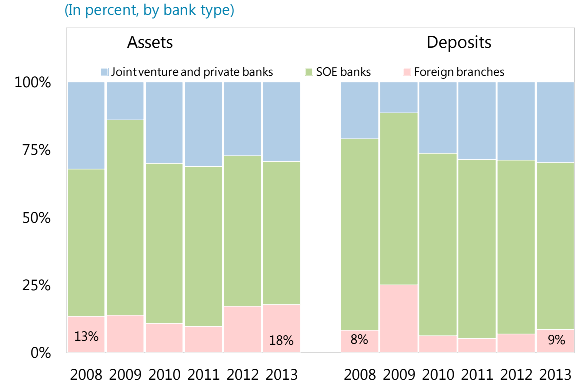
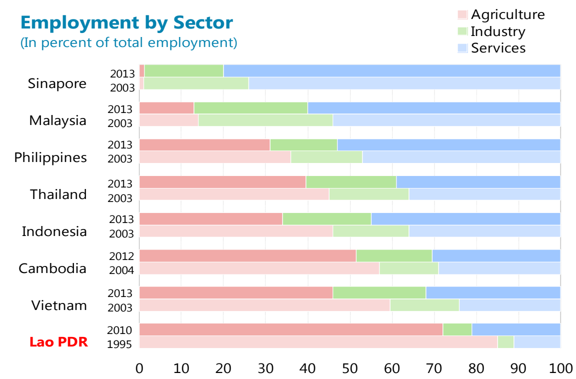
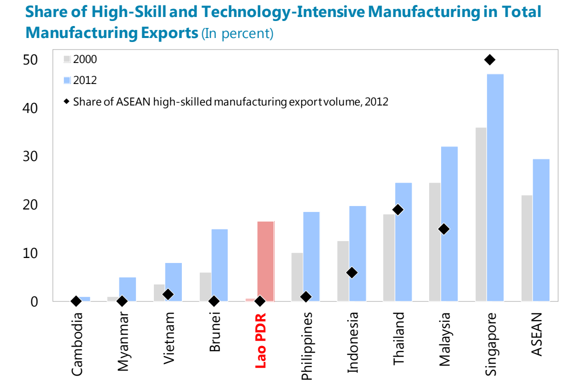


Figure 6. Labor Market Developments[1]

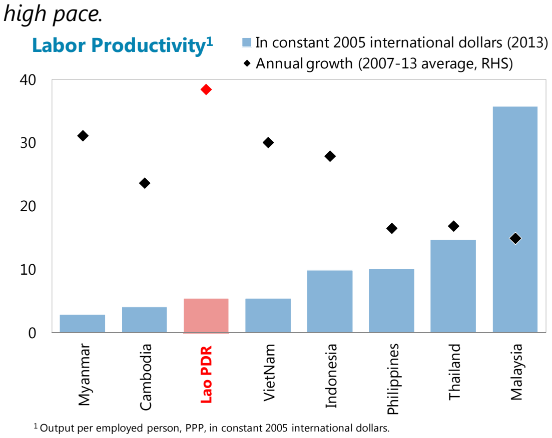
Employment remains concentrated in agriculture.



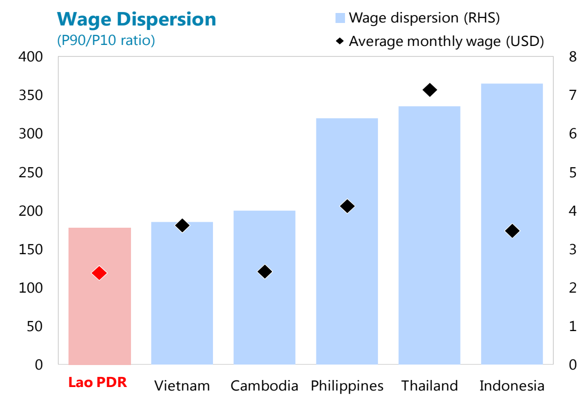
High-skilled and technology-intensive manufacturing exports have become more prominent.



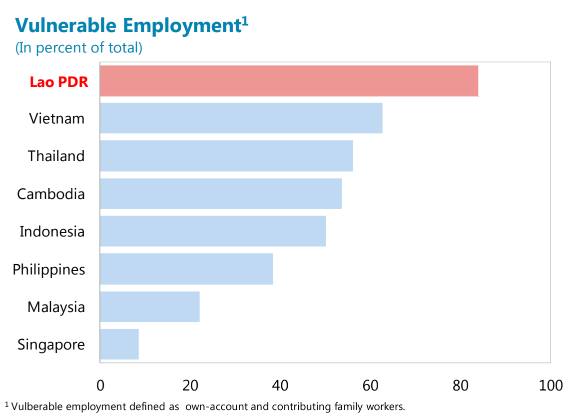
Overall labor productivity is low compared to richer ASEAN countries, but has been growing at steady and high pace.



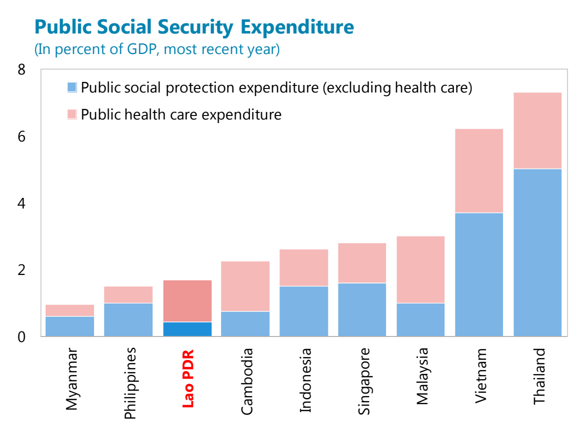
Average wages and wage inequality are relatively low.



The share of vulnerable employment is high by regional standards…



…in part reflecting low social safety net.



Sources: ILO: *ASEAN Community 2012: Managing integration for better jobs and shared prosperity;* and IMF staff estimates and calculations.

[1] 2010 or latest available estimate for Lao P.D.R.

Table 1. Lao P.D.R.: Selected Economic and Financial Indicators, 2010–15 1/

	2010	2011	2012	2013	2014	2015
				Est.	Proj.	
GDP and prices (percentage change)						
Real GDP growth	8.1	8.0	7.9	8.0	7.4	7.2
CPI (annual average)	6.0	7.6	4.3	6.4	4.3	5.0
CPI (end year)	5.8	7.7	4.7	6.6	3.6	5.6
Public finances (in percent of GDP)						
Revenue and Grants	22.6	22.4	24.1	23.9	23.6	22.5
Of which : Resources	2.6	3.4	3.9	3.0	2.8	2.3
Of which : Mining	1.8	2.5	3.2	2.2	2.0	1.6
Of which : Hydro power	0.8	0.9	0.7	0.8	0.7	0.8
Of which : Grant	6.7	6.0	6.4	5.7	5.3	4.8
Expenditure	25.9	24.1	24.6	29.6	27.9	27.2
Expense	11.2	11.3	12.0	17.3	15.5	16.2
Net acquisition of nonfinancial assets 2/	14.6	12.9	12.6	12.3	12.3	10.9
Overall balance	-3.2	-1.7	-0.5	-5.6	-4.2	-4.7
Nonmining balance 3/	-5.0	-4.3	-3.7	-7.8	-6.3	-6.2
Money and credit (annual percent change)						
Reserve money	48.6	16.2	27.2	7.7	22.6	20.8
Broad money	39.5	28.7	31.0	17.0	16.6	23.7
Bank credit to the economy 4/	48.4	45.8	26.6	34.5	15.7	23.8
Bank credit to the private sector	48.4	39.3	35.1	36.3	14.0	24.0
Balance of payments						
Exports (in millions of U.S. dollars)	2,196	3,120	3,323	3,882	4,119	4,498
In percent change	44.4	42.1	6.5	16.8	6.1	9.2
Imports (in millions of U.S. dollars)	3,574	4,635	6,340	7,283	7,604	7,756
In percent change	23.6	29.7	36.8	14.9	4.4	2.0
Current account balance (in millions of U.S. dollars)	-1,369	-1,393	-2,838	-3,123	-2,913	-2,726
In percent of GDP	-20.0	-17.3	-30.2	-28.9	-25.0	-21.3
Gross official reserves (in millions of U.S. dollars)	728	677	740	662	750	870
In months of prospective goods and services imports	1.8	1.2	1.1	1.0	1.1	1.2
External public debt and debt service						
External PPG debt						
In millions of U.S. dollars	3,348	3,769	4,500	5,092	5,601	6,118
In percent of GDP	48.1	46.7	47.7	48.3	48.5	48.7
External PPG debt service						
In percent of exports	4.3	2.6	4.0	5.1	4.8	5.2
Exchange rate						
Official exchange rate (kip per U.S. dollar; end-of-period)	8,066	8,019	7,982	8,030	…	…
Real effective exchange rate (2005=100)	125.4	128.3	133.8	141.7	…	…
Nominal GDP						
In billions of kip	56,523	64,727	75,251	84,572	94,340	106,655
In millions of U.S. dollars	6,842	8,062	9,400	10,788	11,642	12,801

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

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

Table 2. Lao P.D.R.: Balance of Payments, 2010–15

	2010	2011	2012	2013	2014	2015
					Projection	
(In millions of U.S. dollars; unless otherwise indicated)						
Current account	-1,369	-1,393	-2,838	-3,123	-2,913	-2,726
Merchandise trade balance	-1,379	-1,515	-3,017	-3,401	-3,485	-3,258
Exports, f.o.b.	2,196	3,120	3,323	3,882	4,119	4,498
Mining and hydropower	1,500	1,834	1,916	1,983	1,904	2,061
Other exports	696	1,286	1,407	1,899	2,215	2,437
Imports, c.i.f.	3,574	4,635	6,340	7,283	7,604	7,756
Mining and hydropower	728	1,447	1,648	2,155	2,234	2,170
Mining projects	354	436	488	521	434	446
Hydropower projects	374	1,012	1,161	1,634	1,801	1,724
Petroleum imports	412	585	626	669	719	726
Other imports	2,434	2,603	4,065	4,459	4,650	4,860
Services (net)	248	228	236	247	390	433
Of which: Tourism	382	406	514	565	621	684
Income (net)	-417	-329	-309	-206	-180	-298
Interest payments	-127	-105	-135	-160	-163	-173
Of which: Public	-33	-17	-48	-81	-92	-114
Mining and hydropower	-86	-82	-81	-71	-54	-47
Mining projects	-6	-10	-14	-10	0	0
Hydropower projects	-79	-72	-67	-61	-54	-47
Dividends and profit repatriation	-525	-616	-544	-345	-290	-392
Of which: Mining and hydropower	-470	-561	-487	-287	-230	-329
Of which : Mining projects	-445	-503	-424	-241	-176	-204
Hydropower projects	-26	-57	-63	-46	-54	-125
Other	235	392	370	298	274	266
Transfers (net)	179	223	252	238	361	397
Private	70	74	83	88	176	194
Official	109	149	169	150	185	203
Capital and financial account	1,471	1,349	2,903	3,046	3,002	2,847
Public sector	108	98	247	229	508	517
Disbursements	188	176	355	384	654	683
Amortization	-80	-78	-108	-155	-146	-166
Banking sector (net)	-29	23	39	380	191	201
Private sector	1,393	1,228	2,617	2,437	2,303	2,129
Foreign direct investment (net) 1/	671	1,210	1,399	1,847	1,852	1,685
Of which: Mining and hydropower projects	250	783	969	1,343	1,592	1,435
Of which: Mining projects	-37	102	94	81	10	15
Hydropower projects	287	681	875	1,262	1,582	1,420
Other private flows and errors and omissions	721	18	1,218	590	451	444
					37	
Overall balance	102	-45	65	-77	89	121
Core Balance (CA+FDI+ODA)	-591	-132	-1,235	-1,090	-811	-594
Financing	-102	45	-65	77	-89	-121
Central bank net foreign assets	-102	45	-65	77	-89	-121
Assets (increase -)	-95	51	-62	78	-88	-120
Liabilities (reduction -)	-7	-6	-3	-1	-1	-1
Memorandum items:						
Current account balance (in percent of GDP)	-20.0	-17.3	-30.2	-28.9	-25.0	-21.3
Excluding official transfers	-21.6	-19.1	-32.0	-30.3	-26.6	-22.9
Gross official reserves	728	677	740	662	750	870
In months of prospective imports of goods and nonfactor services	1.8	1.2	1.1	1.0	1.1	1.2
(Excluding imports associated with large resource projects)	2.5	1.6	1.6	1.4	1.5	1.6
Nominal GDP at market prices	6,842	8,062	9,400	10,788	11,642	12,801

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

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

Table 3. Lao P.D.R.: General Government Operations, 2010/11–2014/15

	2010/11	2011/12	2012/13	2013/14 Est.	2014/15 Proj.
	(In billions of kip)				
Revenue and Grants	13,891	16,958	19,187	21,723	23,305
Of which: Resource revenue 1/	2,098	2,716	...	2,535	2,402
Nonrenewable resources	1,567	2,232	...	1,879	1,611
Renewable resources	531	484	...	656	791
Nonresource revenue	8,084	9,712	...	14,318	15,983
Taxes	9,109	10,915	12,658	14,515	16,499
Of which: Resource revenue 1/	1,702	2,212	...	2,096	1,964
Nonrenewable resources	1,414	1,993	...	1,729	1,557
Renewable resources	288	219	...	367	406
Nonresource revenue	7,407	8,703	...	12,419	14,535
Income and profit taxes	2,136	2,940	3,044	2,748	3,134
Income taxes	543	744	856	939	1,089
Profit taxes	1,592	2,196	2,188	1,809	2,046
Of which: Mining	888	1,287	...	568	667
Of which: Nonmining	705	909	...	1,241	1,379
VAT	2,403	2,827	3,412	3,807	4,492
Excise duties	1,948	2,344	2,734	3,331	4,086
Import duties	965	1,047	1,205	1,548	1,827
Royalties	722	884	912	1,428	1,206
Mining	527	706	700	1,161	891
Hydropower	195	178	212	267	315
Other taxes	936	872	1,352	1,653	1,753
Other revenues	1,073	1,513	1,980	2,338	1,886
Of which: Dividends	507	764	...	1,055	664
Of which: Resource revenue 1/	396	504	...	439	439
Nonrenewable resources	153	239	...	150	54
Renewable resources	243	265	...	289	385
Nonresource revenue	677	1,009	...	1,899	1,447
Grants	3,709	4,531	4,549	4,870	4,920
Expenditure	14,973	17,316	23,701	25,622	28,137
Expense	6,995	8,466	13,852	14,289	16,802
Compensation of employees	2,940	3,560	8,881	8,677	9,301
Transfers	1,866	2,015	2,143	2,429	3,006
Interest payments	431	591	1,005	904	1,385
Of which: External	373	473	467	198	725
Other recurrent (including arrears)	1,758	2,300	1,823	2,280	3,111
Net acquisition of nonfinancial assets	7,977	8,850	9,849	11,332	11,334
Domestically financed (including arrears)	2,699	3,026	3,517	4,803	4,100
Of which: Off-budget	1,130	464	1,352	500	...
Externally financed	5,429	6,003	6,524	6,529	7,234
Net lending/borrowing	-1,081	-357	-4,514	-3,898	-4,831
Net acquisition of financial assets	408	-565	-1,566	295	0
Domestic	408	-565	-1,566	295	0
Foreign	0	0	0	0	0
Net incurrence of liabilities	2,379	2,419	2,232	4,193	4,831
Domestic	1,116	1,380	1,252	3,881	3,863
Foreign	1,262	1,038	981	312	968
Discrepancy	890	2,626	-716	0	0
Memorandum items:					
Net lending including discrepancy	-1,971	-2,984	-3,799	...	...
Nonmining balance 2/	-2,649	-2,589	-6,437	-5,777	-6,443
Operating balance	6,896	8,492	2,623	7,434	6,503
Domestic financing	709	1,946	2,818	3,586	3,863
Mining revenue	1,567	2,232	1,757	3,586	1,611
Hydropower revenue	531	484	667	656	791
Nonresource revenue	8,084	9,712	12,255	14,318	15,983
Real expenditure (percent, year-on-year) 3/	4.8	4.8	26.6	0	0
GDP	62,027	70,343	80,199	91,898	103,576

Table 3. Lao P.D.R.: General Government Operations, 2010/11–2014/15 (concluded)

	2010/11	2011/12	2012/13	2013/14 Est.	2014/15 Proj.
	(In percent of FY GDP, unless otherwise indicated)				
Revenue and Grants	22.4	24.1	23.9	23.6	22.5
Of which: Resource revenue 1/	3.4	3.9	3.0	2.8	2.3
Nonrenewable resources	2.5	3.2	2.2	2.0	1.6
Renewable resources	0.9	0.7	0.8	0.7	0.8
Nonresource revenue	13.0	13.8	15.3	15.6	15.4
Taxes	14.7	15.5	15.8	15.8	15.9
Of which: Resource revenue 1/	2.7	3.1	2.4	2.3	1.9
Nonrenewable resources	2.3	2.8	2.0	1.9	1.5
Renewable resources	0.5	0.3	0.4	0.4	0.4
Nonresource revenue	11.9	12.4	13.4	13.5	14.0
Income and profit taxes	3.4	4.2	3.8	3.0	3.0
Income taxes	0.9	1.1	1.1	1.0	1.1
Profit taxes	2.6	3.1	2.7	2.0	2.0
Of which: Mining	1.4	1.8	1.1	0.6	0.6
Of which: Nonmining	1.1	1.3	1.6	1.4	1.3
VAT	3.9	4.0	4.3	4.1	4.3
Excise duties	3.1	3.3	3.4	3.6	3.9
Import duties	1.6	1.5	1.5	1.7	1.8
Royalties	1.2	1.3	1.1	1.6	1.2
Mining	0.8	1.0	0.9	1.3	0.9
Hydropower	0.3	0.3	0.3	0.3	0.3
Other taxes	1.5	1.2	1.7	1.8	1.7
Other revenues	1.7	2.2	2.5	2.5	1.8
Of which: Dividends	0.8	1.1	0.8	1.1	0.6
Of which: Resource revenue 1/	0.6	0.7	0.5	0.5	0.4
Nonrenewable resources	0.2	0.3	0.2	0.2	0.1
Renewable resources	0.4	0.4	0.4	0.3	0.4
Nonresource revenue	1.1	1.4	1.9	2.1	1.4
Grants 4/	6.0	6.4	5.7	5.3	4.8
Expenditure	24.1	24.6	29.6	27.9	27.2
Expense	11.3	12.0	17.3	15.5	16.2
Compensation of employees	4.7	5.1	11.1	9.4	9.0
Transfers	3.0	2.9	2.7	2.6	2.9
Interest payments	0.7	0.8	1.3	1.0	1.3
Of which: External	0.6	0.7	0.6	0.2	0.7
Other recurrent (including arrears)	2.8	3.3	2.3	2.5	3.0
Net acquisition of nonfinancial assets 4/	12.9	12.6	12.3	12.3	10.9
Domestically financed (including arrears)	4.4	4.3	4.4	5.2	4.0
Of which: Off-budget	1.8	0.7	1.7	0.5	0.5
Externally financed	8.8	8.5	8.1	7.1	7.0
Net lending/borrowing	-1.7	-0.5	-5.6	-4.2	-4.7
Net acquisition of financial assets	-0.7	0.8	2.0	-0.3	0.0
Domestic	-0.7	0.8	2.0	-0.3	0.0
Foreign	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	3.8	3.4	2.8	4.6	4.7
Domestic	1.8	2.0	1.6	4.2	3.7
Foreign	2.0	1.5	1.2	0.3	0.9
Discrepancy	1.4	3.7	-0.9	0.0	0.0
Memorandum items:					
Net lending including discrepancy	-3.2	-4.2	...	...	...
Nonmining balance 2/	-4.3	-3.7	-7.8	-6.3	-6.2
Operating balance	11.1	12.1	6.7	8.1	6.3
Domestic financing	1.1	2.8	3.5	3.9	3.7
Mining revenue	2.5	3.2	2.2	2.0	1.6
Hydropower revenue	0.9	0.7	0.8	0.7	0.8
Nonresource revenue	13.0	13.8	15.3	15.6	15.4
GDP	62,027	70,343	80,199.2	91,898	103,576

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates and projections.
1/ Resource revenue comprises royalties, taxes, and dividends from the mining and hydropower sectors.
2/ Net lending/borrowing minus mining revenues.
3/ Excluding interest payment.
4/ Data was revised to bring on budget grant-financed capital expenditure.

Table 4. Lao P.D.R.: Monetary Survey, 2011–15

	2011	2012	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3 Projection	2014 Q4 Projection	2015 Projection
	(In billions of kip, unless otherwise indicated)										
Bank of Lao P.D.R. (BoL)											
Net foreign assets	5,449	5,994	5,537	4,061	4,535	4,673	5,312	5,099	4,904	5,497	6,726
In millions of U.S. dollars	679	753	716	524	578	583	660	634	610	672	793
Net domestic assets	6,341	8,878	9,379	9,802	9,283	10,545	12,544	13,096	12,773	13,165	15,824
Government (net)	-653	630	606	711	753	432	676	399	319	319	562
Claims	688	1,228	1,218	1,113	1,113	1,119	1,119	1,119	1,119	1,119	1,466
Deposits	-1,341	-598	-612	-402	-360	-687	-443	-720	-800	-800	-904
State-owned enterprises	4,997	4,959	5,964	5,890	5,359	5,642	5,643	6,117	6,190	6,459	7,159
Banks	3,168	3,647	3,658	3,837	4,078	4,223	4,229	4,328	4,323	4,350	5,002
BoL securities	-2,145	-1,786	-2,000	-2,194	-2,147	-1,949	-1,702	-1,439	-1,358	-1,358	-737
Other items (net)	974	1,428	1,151	1,558	1,240	2,197	3,697	3,691	3,299	3,396	3,839
Reserve money	11,113	14,133	14,212	13,331	13,236	15,217	17,855	18,195	17,677	18,662	22,550
Currency in circulation	5,661	7,169	7,517	7,079	7,165	7,906	8,482	8,191	7,758	8,865	10,712
Bank Reserves	5,452	6,964	6,695	6,252	6,071	7,311	9,374	10,004	9,919	9,797	11,838
Of which: Foreign currency	2,304	2,943	2,829	2,642	2,565	3,090	3,961	4,227	4,191	4,140	5,003
Monetary survey											
Net foreign assets	5,711	5,879	4,501	1,635	2,250	2,251	2,996	1,818	940	1,250	1,514
In millions of U.S. dollars	712	738	582	211	287	281	372	226	117	153	178
Of which: Commercial banks	33	-15	-134	-313	-292	-302	-288	-408	-493	-519	-614
Net domestic assets	21,535	29,826	32,964	35,823	36,689	39,532	41,620	43,763	44,027	47,490	58,781
Government (net)	-1,211	2,032	1,838	2,411	2,571	1,872	1,328	1,938	2,056	2,056	2,325
Credit to the economy	24,104	30,525	34,243	36,183	37,710	41,066	42,135	43,668	43,813	47,518	58,813
In kip	10,927	14,909	16,906	18,667	19,951	21,098	21,423	22,055	22,650	24,565	30,404
In foreign currencies	13,177	15,616	17,337	17,516	17,759	19,968	20,712	21,613	21,164	22,953	28,409
Of which: Private credit	17,713	23,934	26,538	28,501	30,578	32,631	33,571	34,158	34,080	37,200	46,128
Other items (net)	-1,358	-2,730	-3,117	-2,771	-3,593	-3,406	-1,843	-1,843	-1,843	-2,085	-2,357
Broad money	27,246	35,705	37,465	37,458	38,938	41,784	44,616	46,439	46,135	48,740	60,295
Currency in circulation	4,844	6,020	6,064	5,457	5,574	6,489.7	6,512.1	5,832.6	5,582.8	3,812	4,715
Kip deposits	10,453	14,517	16,038	16,374	16,703	17,580	18,615	20,240	21,050	23,274	28,792
Foreign currency deposits (FCDs)	11,949	15,169	15,364	15,627	16,662	17,714	19,489	20,367	19,503	21,654	26,788
	(Annual percent change, unless otherwise indicated)										
Reserve money	16.2	27.2	17.3	12.6	13.7	7.7	25.6	36.5	32.7	22.6	20.8
Broad money	28.7	31.0	25.9	27.9	23.1	17.0	19.1	24.0	17.6	16.6	23.7
Credit to the economy	45.8	26.6	29.6	28.2	31.4	34.5	23.0	20.7	16.3	15.7	23.8
Credit to the private sector	39.3	35.1	34.2	34.4	36.5	36.3	26.5	19.8	14.4	14.0	24.0
Memorandum items:											
Velocity	2.4	2.1	2.3	2.3	2.2	2.0	2.1	2.0	2.0	1.9	1.8
Money multiplier	2.5	2.5	2.6	2.8	2.9	2.7	2.5	2.6	2.6	2.6	2.7
Loan/deposit (percent)	85.3	86.1	90.1	94.7	97.0	100.4	95.8	92.5	92.8	91.4	92.9
In kip (percent)	92.5	89.1	90.2	96.9	101.7	104.7	100.7	94.6	93.6	92.3	93.8
In foreign currency (percent)	79.0	83.3	90.0	92.3	92.3	96.0	91.1	90.4	91.9	90.4	92.1
Gross official reserves (in millions of U.S. dollars) 1/	677	740	704	532	583	662	740	713	688	750	870
Net international reserves (in millions of U.S. dollars) 2	392	383	350	183	251	197	168	108	89	166	203
Dollarization rate (FCDs/broad money; in percent)	43.9	42.5	41.0	41.7	42.8	42.4	43.7	43.9	42.3	44.4	44.4
Gross reserve/Reserve Money	49	42	38	31	35	35	33	32	31	33	33
Required reserves	1,515	1,778	1,753	1,834	2,001	2,121	2,308	2,440	2,394	2,655	3,285
Excess reserves (percent of GDP)	4.8	4.9	4.7	4.0	3.6	5.0	6.4	6.9	6.9	6.5	6.9

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

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

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

Table 5. Lao P.D.R.: Medium-Term Macroeconomic Framework, 2010–19

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Projections					
Output and prices	(Percent change, unless otherwise indicated)									
Real GDP	8.1	8.0	7.9	8.0	7.4	7.2	7.7	7.7	7.4	7.5
Consumer prices (annual average)	6.0	7.6	4.3	6.4	4.3	5.0	5.3	5.5	5.5	5.5
Consumer prices (end-period)	5.8	7.7	4.7	6.6	3.6	5.6	6.3	6.3	5.5	5.5
GDP per capita (in U.S. dollars)	1,070	1,236	1,414	1,594	1,688	1,821	1,949	2,089	2,294	2,454
Public finances (in percent of GDP) 1/										
Revenue	22.6	22.4	24.1	23.9	23.6	22.5	22.0	21.8	21.8	21.8
Tax and nontax revenue	16.0	16.4	17.7	18.3	18.3	17.8	17.7	17.8	18.0	18.3
Mining	1.8	2.5	3.2	2.2	2.0	1.6	1.3	1.2	1.2	1.1
Hydro power	0.8	0.9	0.7	0.8	0.7	0.8	1.1	1.0	1.1	1.1
Others	13.4	13.0	13.8	15.3	15.6	15.4	15.3	15.5	15.7	16.1
Grant	6.7	6.0	6.4	5.7	5.3	4.8	4.4	4.1	3.8	3.5
Expenditure	25.9	24.1	24.6	29.6	27.9	27.2	27.4	27.3	27.7	28.4
Expense	11.2	11.3	12.0	17.3	15.5	16.2	16.0	16.3	16.5	17.1
Net acquisition of nonfinancial assets 2/	14.6	12.9	12.6	12.3	12.3	10.9	11.4	11.1	11.2	11.2
Overall balance	-3.2	-1.7	-0.5	-5.6	-4.2	-4.7	-5.4	-5.5	-6.0	-6.5
Primary balance	-2.5	-1.0	0.3	-4.4	-3.3	-3.3	-4.1	-3.6	-3.7	-3.8
Nonmining balance 3/	-5.0	-4.3	-3.7	-7.8	-6.3	-6.2	-6.6	-6.7	-7.2	-7.6
Balance of payments										
Current account balance	-1,369	-1,393	-2,838	-3,123	-2,913	-2,726	-2,455	-2,642	-2,885	-3,042
In percent of GDP	-20.0	-17.3	-30.2	-28.9	-25.0	-21.3	-17.6	-17.3	-16.9	-16.4
Trade balance	-1,379	-1,515	-3,017	-3,401	-3,485	-3,258	-2,994	-3,400	-3,636	-3,822
Exports	2,196	3,120	3,323	3,882	4,119	4,498	4,981	5,333	5,861	6,251
Of which: Resources	1,500	1,834	1,916	1,983	1,904	2,061	2,560	2,658	2,870	2,804
In percent change	44.4	42.1	6.5	16.8	6.1	9.2	10.7	7.1	9.9	6.6
Of which: Resources	64.6	22.3	4.5	3.5	-4.0	8.3	24.2	3.8	8.0	-2.3
Imports	3,574	4,635	6,340	7,283	7,604	7,756	7,975	8,733	9,497	10,073
Of which: Resources	728	1,447	1,648	2,155	2,234	2,170	2,010	1,984	2,046	2,000
In percent change	23.6	29.7	36.8	14.9	4.4	2.0	2.8	9.5	8.8	6.1
Of which: Resources	-18.6	98.8	13.9	30.8	3.7	-2.9	-7.4	-1.3	3.1	-2.3
Services and income (net)	-169	-101	-73	41	211	135	105	162	106	168
Transfers	179	223	252	238	361	397	435	596	645	612
Capital account balance	1,471	1,349	2,903	3,046	3,002	2,847	2,582	2,964	3,206	3,217
Of which: FDI	671	1,210	1,399	1,847	1,852	1,685	1,637	2,122	2,315	2,315
Overall balance	102	-45	65	-77	89	121	128	321	321	175
Debt and debt service (excluding unidentified arrears)										
Public and public guaranteed debt (in percent of GDP)	58.1	57.2	59.4	59.5	59.7	60.1	61.6	62.8	62.5	64.4
Public Domestic debt (in percent of GDP)	10.0	10.5	11.7	11.1	11.2	11.4	13.7	15.9	17.8	20.3
External debt (in percent of GDP)	75.4	76.4	79.7	85.2	91.2	92.0	88.6	84.5	77.5	73.9
External public and public guaranteed debt (in percent of GDP)	48.1	46.7	47.7	48.3	48.5	48.7	47.9	46.9	44.7	44.1
External public debt service (in percent of exports)	4.3	2.6	4.0	5.1	4.8	5.2	5.9	6.5	7.5	8.1
Gross official reserves										
In millions of U.S. dollars	728	677	740	662	750	870	997	1,318	1,638	1,812
In months of imports	1.8	1.2	1.1	1.0	1.1	1.2	1.3	1.6	1.8	2.0
In months of imports (excluding resource projects)	2.5	1.6	1.6	1.4	1.5	1.6	1.6	2.0	2.3	2.3
Memorandum items:										
Nominal GDP (in billions of kip)	56,523	64,727	75,251	84,572	94,340	106,655	121,128	138,125	160,847	181,768

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

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

Table 6. Lao P.D.R.: Financial Soundness Indicators, 2010–14
(In percent)

	2010	2011	2012	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2
Capital-to-Asset Ratio									
State-owned	4.8	6.0	...	4.9	6.7	6.6	6.7	3.4	2.9
Private	34.1	...	...	24.6	26.1	25.4	30.3	30.7	27.7
Joint-venture	9.9	...	...	15.2	13.8	14.0	12.1	17.1	16.2
Foreign banks	37.7	...	...	42.3	47.0	65.7	54.3	57.8	48.6
Nonperforming Loans (percent of total loans)									
State-owned	1.5	...	...	2.7	2.4	2.8	2.7	7.3	8.2
Private	1.2	...	...	1.0	0.9	3.0	1.9	2.1	4.0
Joint-venture	1.6	...	...	6.3	6.2	4.5	3.8	3.7	4.2
Foreign banks	10.8	...	...	0.1	0.1	0.1	0.1	0.1	0.2
Credit (percent of total)									
State-owned	...	...	...	...	...	...	...	57	56
Private	...	...	...	...	...	...	...	19	19
Joint-venture	...	...	...	...	...	...	...	9	10
Foreign banks	...	...	...	...	...	...	...	15	16
Total assets (percent of total)									
State-owned	...	...	...	...	...	...	...	53	52
Private	...	...	...	...	...	...	...	19	18
Joint-venture	...	...	...	...	...	...	...	11	11
Foreign banks	...	...	...	...	...	...	...	17	19
Commercial banks' credit (percent of total)									
Industry and handicraft	19	20	16	...	...	...	18	19	19
Construction	12	13	18	...	...	...	21	21	21
Materials and supplies	5	4	4	...	...	...	5	3	3
Agriculture	16	13	8	...	...	...	10	10	10
Trading/commerce	23	21	24	...	...	...	21	21	20
Transportation	4	4	4	...	...	...	4	4	4
Services	13	17	16	...	...	...	12	11	11
Others	9	8	10	...	...	...	10	10	11

Sources: Bank of Lao P.D.R.; and CEIC.

Table 7. Lao P.D.R.: Summary of Illustrative Scenarios, 2013–19

(In percent, unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019
		Projection					
Baseline							
Real GDP growth (percent)	8.0	7.4	7.2	7.7	7.7	7.4	7.5
CPI inflation (EOP)	6.6	3.6	5.6	6.3	6.3	5.5	5.5
Fiscal deficit 1/	-7.8	-6.3	-6.2	-6.6	-6.7	-7.2	-7.6
Current account	-28.9	-25.0	-21.3	-17.6	-17.3	-16.9	-16.4
Capital account	28.2	25.8	22.2	18.5	19.4	18.8	17.3
Overall balance	-1.0	1.1	1.4	1.5	3.5	3.4	1.8
Reserves (in millions of U.S. dollar)	662	750	870	997	1,318	1,638	1,812
Reserves (months of imports)	1.0	1.1	1.2	1.3	1.6	1.8	2.0
REER (percent depreciation)	…	…	0.0	0.0	0.0	0.0	0.0
External public debt	48.3	48.5	48.7	47.9	46.9	44.7	44.1
Public Debt	59.4	59.7	60.1	61.6	62.8	62.5	64.4
Alternative Scenario							
Real GDP growth (percent)	8.0	7.4	6.8	7.3	7.4	7.3	7.2
CPI Inflation (EOP)	6.6	3.6	5.9	6.6	6.4	5.4	4.5
Fiscal deficit 1/	-7.8	-6.3	-4.8	-4.8	-5.0	-5.0	-5.0
Current account	-28.9	-25.0	-20.1	-14.5	-15.5	-15.3	-14.3
Capital account	28.2	25.8	22.7	19.0	20.0	19.5	18.0
Overall balance	-1.0	1.1	2.6	4.5	4.5	4.2	3.6
Reserves (in millions of U.S. dollar)	662	750	1,073	1,686	2,358	3,041	3,691
Reserves (months of imports)	1.0	1.1	1.7	2.4	3.1	3.8	4.3
REER (percent depreciation)	…	…	0.3	0.3	0.9	1.9	2.8
External public debt	48.3	48.5	49.2	48.6	47.7	46.0	45.4
Public debt	59.4	59.7	61.4	61.3	61.2	59.6	59.4

Source: IMF staff estimates and calclations.

1/ Nonmining deficit, percent of fiscal year GDP.

Table 8. Lao P.D.R.: Millennium Development Goals Indicators

Millennium Development Goals	Indicator	Baseline	Current Status	2015 Target
1. Eradicate extreme poverty and hunger	Proportion of population below the national poverty line 1/	46	23.2	24
	Employment-to-population ratio	84.9	77.7	No target
	Prevalence of underweight children under five years of age	44	27	22
	Prevalence of stunting in children under five years of age	48	44	34
2. Achieve universal primary education	Proportion of pupils starting grade 1 who reach grade 5	48	70	95
	Literacy rate in the age group of 15–24 years	71	73.1	99
3. Promote gender equality and empower women	Number of girls per 100 boys enrolled in:			
	Primary	79	91	100
	Lower secondary	70	89	100
	Upper secondary	67	83	100
	Tertiary	42	77	100
	Share of women in wage employment	38	34	No target
4. Reduce child mortality	Under–five mortality rate	170	79	70
	Proportion of one-year-old children immunized against measles	33	55	90
5. Improve maternal health	Proportion of births attended by skilled birth personnel	14	42	50
	Maternity mortality rate (per 100,000 live births)	796	357	260
6. Combat HIV/AIDS, malaria, and other diseases	HIV prevalence among general population (percentage)	0.1	0.28	less than 1
7. Ensure environmental sustainability	Proportion of land areas covered by forests (percentage)	49.1	40.3	65
	Consumption of ozone-depleting substances (mt)	43.3	2.5	0

Source: United Nations and Government of Lao P.D.R.

1/ Provisional poverty estimate for Lao P.D.R. for 2012/13.

INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS[1]

December 15, 2014

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International Monetary Fund
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The risk of Lao P.D.R. facing external debt distress remains moderate, but it is on the cusp of a transition to high risk, with heightened vulnerabilities for public debt.[2] External debt distress indicators are more elevated than in last year's DSA, owing to the higher initial external PPG debt stock and projected debt flows to support public investment, and less concessional borrowing terms over time. Buffers are very limited in the case of adverse shocks. Given the considerable share of foreign currency denominated debt, large and sudden exchange rate depreciation could significantly raise the debt-to-GDP and the debt service-to-revenue trajectories for external and public debt; though revenues from large resource projects are expected to mitigate risks over the long term. While the change in external risk rating is not warranted at this time because baseline breaches of the thresholds under both the traditional and probability approaches are minor and temporary, the breaches do suggest heightened vulnerabilities, which should be addressed through fiscal consolidation, as recommended by staff, and by strengthening public investment management capacity.

[1] This DSA has been prepared by IMF and World Bank staffs, in consultation with the Lao P.D.R. authorities.

[2] The low-income country debt sustainability framework (LIC DSF) recognizes that better policies and institutions allow countries to manage higher levels of debt, and thus the threshold levels for debt indicators are policy-dependent. In the LIC-DSF, the quality of a country's policies and institutions is measured by the World Bank's Country Policy and Institutional Assessment (CPIA) index and classified into three categories: strong, medium, and weak. Lao P.D.R.'s policies and institutions, as measured by the CPIA, averaged 3.37 over the past three years. Since its average CPIA index has been above 3.25 for three years in a row, Lao P.D.R.'s policy performance remains classified as medium according to the "Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-income Countries" (www.imf.org/external/np/pp/eng/2010/012210.pdf). Therefore, the relevant indicative thresholds for this category are: 40 percent for the PV of debt-to-GDP ratio, 150 percent for the PV of debt-to-exports ratio, 250 percent for the PV of debt-to-revenue ratio, 20 percent for the debt service-to-exports ratio, and 20 percent for the debt service-to-revenue ratio. These thresholds are applicable to public and publicly guaranteed external debt.

BACKGROUND

1. The 2013 Debt Sustainability Analysis (DSA) classified Lao P.D.R.'s risk of debt distress as moderate. The classification continues to depend on the favorable Country Policy and Institutional Assessment (CPIA) index.[3]

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

	Indicative thresholds	End-2013
Present value of debt, in percent of:		
GDP	40	40
Exports	150	92
Revenue	250	221
Debt service, in percent of:		
Exports	20	5
Revenue	20	12

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

2. This DSA continues to classify the risk of debt distress as moderate, but Lao P.D.R. is on the verge of a transition to high risk, with heightened vulnerabilities for public debt. The indicative debt distress thresholds remain unchanged from the 2013 Article IV DSA. Under the baseline scenario of the current DSA, some of the external and public debt distress indicators breach the policy-dependent indicative thresholds for some years, the PV of external debt follows a downward trend and returns to levels below the respective thresholds in the medium term. Given the traditional approach classifies the debt distress risk as borderline high/moderate, a probability approach is adopted. The results of the probability approach suggest moderate debt distress risks, since all the indicators remain under their corresponding thresholds, with the exception of debt-to-GDP ratio, which breaches the threshold for a brief period.

3. Lao P.D.R.'s external public and publicly guaranteed (PPG) debt remains elevated and has risen since 2012. The nominal stock of PPG external debt increased from US$4.5 billion in 2012 to about US$5.1 billion at end-2013, mainly the result of higher borrowing from Thailand and China. The rise in debt was in part driven by heavy investment in power generation projects. Thus, the PPG external debt rose from 47.7 percent of GDP in 2012 to 48.3 percent of GDP at end-2013. The corresponding net present value (PV) of PPG external debt was 39.8 percent of GDP, a significant increase from 32.5 percent of GDP at end-2012, primarily because the amortization schedule of existing debt puts the larger part of principal repayments on more recent years compared to the last DSA.

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

	U.S. dollar (billion)	Share of total PPG external debt (percent)	In percent of GDP
Total	5.1	100	48
Multilateral	1.8	36	17
Bilateral	3.3	64	31
Commercial[1]	0.1	3	1

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

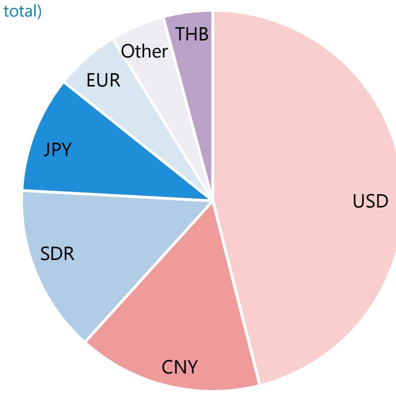
[1] Commercial debt includes Thai bond issuance.

4. Bilateral creditors have taken a larger share than multilateral creditors in 2013, and this trend is expected to continue in the projection period. Bilateral creditors—mainly China, Russia, Thailand, Japan, and Korea—account for 64 percent of total external PPG debt at end-2013. Multilateral

[3] Lao P.D.R.'s CPIA index declined marginally in 2013, not sufficient to change the classification of its policy performance, which remains moderate.

creditors consist mainly of the Asian Development Bank (AsDB—20 percent of total external PPG debt), and the International Development Association (IDA—12 percent of total external PPG debt).

Currency Composition of External PPG Debt
(In percent of total)



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

5. About three-quarters of total external PPG outstanding debt was contracted in U.S. dollars, renminbi, and SDR. The rest consists of yen, euro, Thai baht and others.

6. The high level of concessionality of official borrowing helps to keep the external debt service ratios at manageable levels. PPG external debt service indicators are expected to remain below the policy-dependent indicative thresholds throughout the projection period in the baseline. However, given almost half of total external PPG debt is contracted in U.S. dollars and declining concessionality of new borrowing under the current DSA assumptions, the debt to GDP and debt service ratios of external PPG debt are most sensitive to large sudden currency depreciation shocks. Given very thin buffers, other adverse shocks, including delayed fiscal consolidation, could push the stock of external PPG debt beyond sustainable levels, with some debt distress indicators breaching their respective thresholds.

7. The rising external debt-to-GDP ratio and near-term threshold breaches underscore the need to strengthen debt management capacity. This includes ensuring that debt sustainability considerations are taken into account when contracting new debt, particularly because the country is expected to shift from concessional to more market-based terms as it graduates from Least Developed Country (LDC) status. Additional near-term external borrowing, for example to finance mega-projects, could push the debt-to-GDP ratio over the indicative thresholds for a protracted period, potentially jeopardizing debt sustainability. A mitigating factor for Lao P.D.R.'s external debt burden lies in the prospective returns on the hydropower and mining projects that have been financed in part by the external PPG debt. The long-term power purchase agreements that are singed for these projects and the resulting government revenues in the form of royalties, dividends, and profit tax payments help reduce the risk of debt distress in the long run.

8. Recorded domestic PPG debt (excluding arrears) declined marginally from 12 percent of GDP in 2012 to about 11 percent of GDP at end-2013.[4] Domestic debt consists of commercial bank lending and bond holdings as well as Bank of the Lao P.D.R.'s direct lending to local government's off-budget infrastructure projects. Given higher costs of domestic borrowing, the share of domestic PPG debt remains relatively small. Going forward, however, as domestic financial markets deepen, the share of domestic public debt is likely to increase. Financing through arrears accumulation allows total domestic and external PPG debt to remain at about 59 percent of GDP at end-2013, similar to the year before.

[4] Recorded domestic PPG debt (excluding arrears) declined marginally in 2013 as due to accumulation of arrears.

ASSUMPTIONS UNDERLYING THE DEBT SUSTAINABILITY ANALYSIS

Lao P.D.R.: Macroeconomic Assumptions Comparison with 2013
(Average over the 20 years projection period)

	2013 DSA	2014 DSA
GDP growth	6.9	6.6
GDP deflator in U.S. dollar terms (percent)	2.2	1.5
Non-interest current account deficit	12.3	10.6
Primary deficit	1.6	1.9

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

9. The medium-term macroeconomic assumptions underlying the DSA are summarized in Box 1. The baseline scenario--which is based on current policies and consistent with the macroeconomic framework presented in the staff report—projects annual GDP growth to moderate to 7.4 and 7.2 percent in 2014 and 2015, respectively, before reverting toward 7.5 percent in the medium term. Average real GDP growth over the projected period is expected to be lower than in 2013 DSA, in large part due to lower projected mining sector growth. GDP deflator growth (in USD terms) is projected to be about 1 percent, lower than in 2013 DSA, on account of the subdued global commodity and import price outlook and moderately lower real GDP growth. The bilateral exchange rate vis-à-vis USD is expected to depreciate by about 3.5 percent year-on-year starting in 2016 and thereafter, consistent with the authorities' exchange rate band of +/-5 percent.

10. Compared to the 2013 DSA, the baseline projects slight improvement in the external position, but deterioration in the fiscal position. The current account deficit is projected to improve over the forecast period and also compared to the 2013 DSA. On the fiscal side, the primary deficit is expected to deteriorate in the medium term, worse than 2013 DSA.

11. As a result, a higher level of financing than last year is assumed. To meet the country's financing needs, a higher level of new borrowing is projected to finance investment that would support the country's ambition to graduate from the LDC status by 2020. External financing is assumed to remain largely on concessional terms in the near future. Going forward, however, the new disbursement schedule is assumed to rely less on multilateral creditors, and more on bilateral and commercial creditors. In this vein, the share of commercial borrowing is projected to reach about 10 percent of total new disbursements in the long term. Multilateral assistance will slowly shift from grant- to credit-based conditions, and AsDB and the World Bank Group are expected to remain the principal suppliers of multilateral credit, with IDA loans slowly phasing out and replaced by IBRD loans with less concessional terms. The level of grant financing is projected to decline from 5.6 percent of GDP in 2013 to about 3.5 percent of GDP in the medium term, adding to the higher projected borrowing needs, which are estimated to be higher than the authorities' disbursement projections. Interest rates on bilateral and commercial loans are expected to increase with libor, in line with the assumptions from the IMF's World Economic Outlook, and stabilize at a higher level in the medium term. As the domestic financial market deepens, the private sector is assumed to rely more on domestic sources of financing, lowering the need for foreign borrowing in the long term.

Box 1. Baseline Scenario – Underlying Assumptions (2014–34)

The baseline macroeconomic framework assumes neutral fiscal stance in the medium-term, followed by some consolidation, and accommodative monetary conditions. Although long-term growth is still anchored by the vigorous energy production sector, vulnerabilities remain heightened.

Real GDP growth is projected to average 7.5 percent during 2014–19. Growth has slowed in FY2014, partly due to fiscal tightening and lower mining production. In the medium term, some fiscal easing and higher growth in the resource sector, driven by the commencing of operation of some power projects, will return growth to about 7½ percent. This outlook also relies on continued accommodative monetary policy, vigorous resource-related FDI inflows, rising electricity demand from neighboring countries, and a gradual pickup of investment inflows into nonresource sectors following Lao P.D.R.'s recent WTO accession. Over the longer term, successful structural reforms would create a better environment for private investment, broadening the sources of growth. Real GDP is expected to moderate to 6.3 percent on average during 2020–34, as production in the resource sector reaches maturity. Graduation from Least Developed Country status is projected around early-2020s.

Inflation (measured by GDP deflator in USD terms) is projected to average about 1.5 percent in 2014–34. Price growth is expected to remain subdued, owing to weaker food and fuel price growth outlook and declining domestic pressures.

The balance of payments continues to be driven by developments in the resource sector, which has an important bearing both the current account and the capital and financial account. The current account deficit is estimated to have narrowed slightly to about 28.9 percent of GDP in 2013 and is expected to decline to 25 percent of GDP in 2014, as the nonresource deficit remains elevated and the resource deficit temporarily increases before large-scale power projects come on stream in 2015–16. FDI inflows are assumed to be vigorous, driven by growing investment inflows into both resource and nonresource sectors following Lao P.D.R.'s recent WTO accession. The current account is projected to improve over medium and long term, assuming that nonresource exports and services will gradually pickup driven by solid recovery in advanced economies, strengthened regional integration, supported by improvements in the investment climate, streamlining of business regulations, and the prevalence of trade commitments.

External financing is assumed to remain largely on concessional terms in the near term. In the longer-run, however, the degree of concessional financing decreases with economic development, while new disbursement schedule will shift from multilateral to commercial and bilateral creditors.
Multilateral creditors: Projected loan disbursements in the medium term are relatively low, since IDA and AsDB have a pipeline of operations financed on grant terms, which are forecast to roll over into loans with decreasing levels of concessionality going forward. Over the longer term, project loans are assumed to increase moderately, but the share of multilateral loans in total disbursements are expected to decline over the long run.

- Under the IDA pipeline, half of new disbursements starting in FY 2014 are expected to be financed through grants and half through loans on concessional terms. Given the expected graduation of Lao P.D.R. from the LDC status, beginning in FY 2021 half of the disbursements are expected to be financed under IDA terms and half under IBRD terms, and starting in FY 2024 all financing by the World Bank Group is expected to shift to IBRD terms with less concessional conditions.

- AsDB loans are expected to remain on concessional terms. New projects for 2015 to 2035 are assumed at US$85 million per year, which is the average of Lao P.D.R.'s indicative lending allocations as set out in the Work Program and Budget Framework for 2015–17, with the addition of US$27 million per year for additional allocation for subregional project, based on the annual average of 2013–14 subregional allocations.

Bilateral and Commercial Creditors: For 2014–19, project loan disbursements also increase, as donors provide support to the government's development agenda. Over the medium and longer term, greater participation by new emerging market creditors results in an increased role for bilateral finance, including on-lending to state-owned enterprises. As Lao P.D.R. exits from low income country status, larger share of external borrowing is expected to shift from multilateral to bilateral and commercial creditors, with lower degree of concessionality on market-based terms. The share of commercial creditors is expected to increase over the projection period to about 10 percent of total new borrowing. Given the anticipated increase in global interest rates due to the exit from unconventional monetary policy in the US, interest rates for bilateral and commercial borrowing are expected to start rising in 2015 in line with the World economic Outlook's libor forecasts. DSA assumptions also incorporate historical and projected bond issuance initiative in the Thai market. So far, a 50-million USD bond has been issued in May 2013, two bonds totaling US$100 million have been issued in December 2013, and a 170 million USD bond has been issued in October 2014.

Fiscal policy is projected to be neutral in the medium-term. The primary deficit is projected to peak at 3.6 percent of GDP in 2016 and remain at about 3.4 percent of GDP on average over the medium term, then decline gradually to around 1.4 percent of GDP on average. Over the long-term the primary deficit is expected to stabilize at around 0.7 percent as improvements in non-mining revenue collection are counteracted by declines in mining and resource related revenue, while capital expenditure is expected to decline and other expenditure categories are expected to remain constant as a percent of GDP.

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

DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

12. Under the baseline scenario, the PV of external debt to GDP ratio is projected to be above the policy dependent indicative threshold and decline in the medium term (Figure 1), indicating that the debt distress risk is more elevated than the 2013 DSA. The change is driven primarily by the higher debt stock at the end of 2013, and higher projected new borrowing, with less concessional terms going forward as Lao P.D.R. graduates from the LDC status. As a result, the current DSA forecasts a breach in the PV of external PPG debt-to-GDP ratio until 2018. Other debt and debt service indicators remain below the policy-dependent indicative threshold during the entire forecast period under the baseline scenario.

13. Under the historical scenario, in which key variables are set at their historical averages, debt dynamics become unsustainable for all debt stock indicators. The historical scenario is based on 10-year averages of higher current account deficit, real GDP growth, and growth of exports of goods and services than assumed under the baseline, requiring higher debt accumulation rates and putting debt dynamics on an unsustainable path.

14. Debt dynamics continue to be markedly worse under the alternative scenarios, with the exchange rate depreciation risk having the largest impact. Abrupt exchange rate depreciation remains the most important risk to sustainability, given a large share of foreign currency debt and a very thin international reserves cushion. A potential trigger is an increase in global interest rates, as advanced economies exit from unconventional monetary policies. As shown in Figure 1, a one-off 30 percent depreciation shock would cause the breach of the indicative threshold of the PV of debt-to-GDP, debt-to-revenue, and debt service-to-revenue ratios over a prolonged period. While the PV of external PPG debt declines over the projection period, liquidity indicators worsen, as indicated by the increasing debt service ratios. This raises concerns about possible foreign-currency liquidity crunch. However, given the expected increase in revenues from hydropower production, which are not fully captured by fiscal revenues, debt service-to-exports ratio, rather than debt service-to-revenue ratio, is a more appropriate indicator. A somewhat worse debt trajectory emerges as a result of an assumed negative shock to FDI inflows—a scenario with net official transfers and net FDI falling in 2014-15 below their historical averages—in which case Lao P.D.R. would be forced to reduce its current account deficit in order to avoid worsening the external debt position.

15. The borderline high/moderate case issue was addressed with the probability approach, which suggests moderate risk of debt distress, but verging on a transition to high risk. Given the small breach under the baseline and multiple breaches of thresholds under the alternative scenarios, the debt distress risk is classified as high/moderate. To address the borderline issue, a so-called probability approach was adopted. The key difference is that the probability approach incorporates a country's individual CPIA score and average GDP growth rate, whereas the traditional approach uses one of three discrete CPIA values (for weak, medium, and strong performers) and an average growth rate across LICs. Under the baseline scenario, the probability of debt distress is lower than the threshold for all indicators, with the PV of debt-to-GDP ratio breaching its threshold only briefly. The risk of debt distress is sensitive to significant exchange rate depreciation and under a historical scenario, in which case the stress tests result in multiple breaches of thresholds. This is consistent with moderate risk of debt distress.

B. Public Debt Sustainability Analysis

16. The PV of total PPG debt in percent of GDP and in percent of revenue are both projected to remain elevated over the long run under the baseline scenario. Current public sector debt dynamics show a worsening situation than in 2013 DSA. The PV of public sector debt was estimated at 50.5 percent of GDP in 2013 and is expected to remain high and above the threshold until the end of the projection period in the baseline scenario. The breach is primarily driven by faster amortization schedule on existing 2013 debt and higher projected disbursement schedule necessary to support growth in the conditions of fiscal easing and limited public investment management and implementation capacity. Given the underlying assumptions of the eventual shift from concessional to market-based borrowing terms and higher borrowing interest rates over time, Lao P.D.R.'s PPG debt-to-GDP, debt-to-revenue, and debt service-to-revenue ratios are expected to increase over the projection period.

17. The worsened baseline and the alternative scenarios from last year's DSA highlight the growing risk of debt distress and point to the importance of fiscal consolidation over the medium term. As shown by the fixed primary balance scenario, which assumes unchanged primary balance from 2014 for the entire projection period, the PV of the debt-to-GDP and debt-to-revenue ratios would be higher than the baseline in the second half of the projection period.

18. Owing to significant reliance on external borrowing, the PV of public debt remains sensitive to large, abrupt exchange rate depreciation. A sudden 30-percent depreciation of the kip against the U.S. dollar would immediately raise the PV of public debt-to-GDP in the medium-term, with unfavorable implications for debt sustainability.

AUTHORITIES' VIEWS

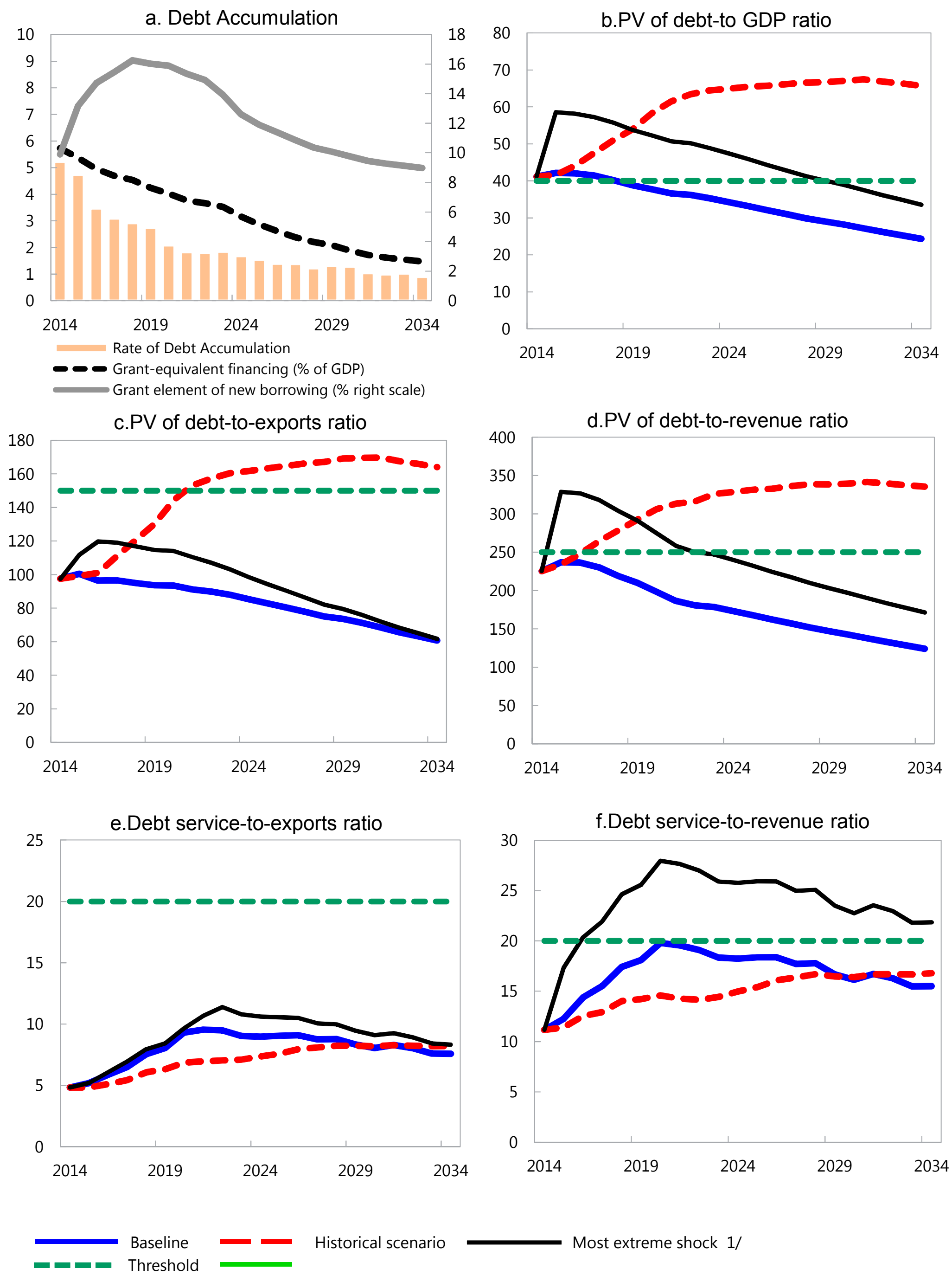
19. The authorities broadly agreed with the overall assessment, emphasizing that the government does not foresee difficulties in servicing debt, and expect lower new borrowing than the DSA assumes. Given the expected strong royalty, dividends, and profits, the authorities do not anticipate any difficulty finding creditors and servicing outstanding loans. A relatively long maturity profile of loans, as well as U.S. dollar returns of the exporting sectors, would help mitigate the risks of debt distress. The authorities anticipate an increase in disbursements of new funds from some bilateral donors between 2014 and 2019, and that borrowing would not expand at the rate assumed in the DSA given a number of current regulations restricting new external commercial borrowing to no more than 25 percent of government revenue. Restrictions on borrowing for infrastructure and social development purposes also allow financing only on concessional terms with interest rates below 3 percent and long-term maturity. Nevertheless, the authorities indicated that these guidelines could be modified should financing needs and financial conditions change. Borrowing is expected to shift from external to domestic sources over time, as domestic financing becomes cheaper. Better access to nonconcessional loans is also expected in the future.

20. The authorities highlighted that a significant part of the external debt is related to viable, large resource projects. They believe that energy sector projects will generate high and stable economic returns upon completion. While going forward, the authorities felt that external borrowing from China will decline, as lending will focus on the energy sector and on guaranteed terms only.

CONCLUSION

21. Although Lao P.D.R.'s risk of external debt distress remains moderate, it is on the cusp of a transition to high risk, with heightened vulnerabilities for public debt. While debt service ratios remain within the policy-dependent indicative thresholds in the baseline, primarily because of the still high concessionality of official borrowing, the PV of external debt to GDP ratio breaches the indicative threshold for some years, leaving almost no buffers in the case of adverse shocks. Given that the traditional approach identifies the risk of debt distress as borderline between moderate and high, a probability approach is adopted, using Laos-specific indicators. The results show that the debt distress probability remains below the threshold in the baseline for all indicators, except the external debt to GDP ratio, which breaches the threshold for a brief period. Also, given the considerable share of foreign currency denominated debt, a large sudden exchange rate depreciation could significantly raise the debt-to-GDP and the debt service-to-revenue trajectories for external and public debt. In that event, the elevated private external debt would also raise concern. Large sudden exchange rate depreciation would put public debt dynamics on an unsustainable path well above the baseline. While the external risk rating does not warrant a change at this time because baseline breaches of the thresholds under both the traditional and probability approaches are minor and temporary, the breaches do suggest heightened vulnerabilities, which should be addressed through fiscal consolidation, as recommended by staff, and by strengthening public investment management capacity.

Figure 1. Lao P.D.R.: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2014–34 1/

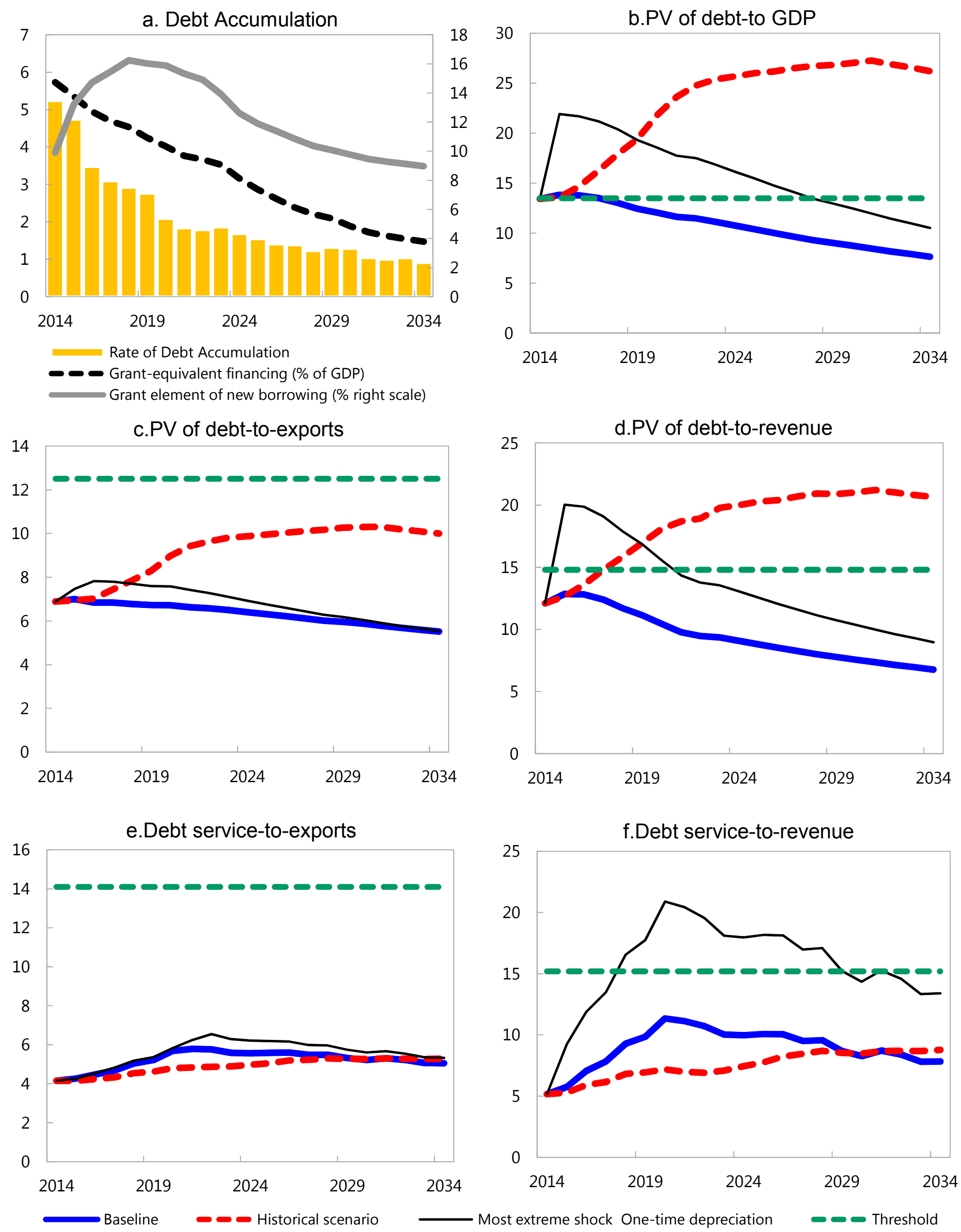


Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a One-time depreciation shock; in c. to a Non-debt flows shock; in d. to a One-time depreciation shock; in e. to a Non-debt flows shock and in figure f. to a One-time depreciation shock

Figure 2. Lao P.D.R.: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2014–34 1/

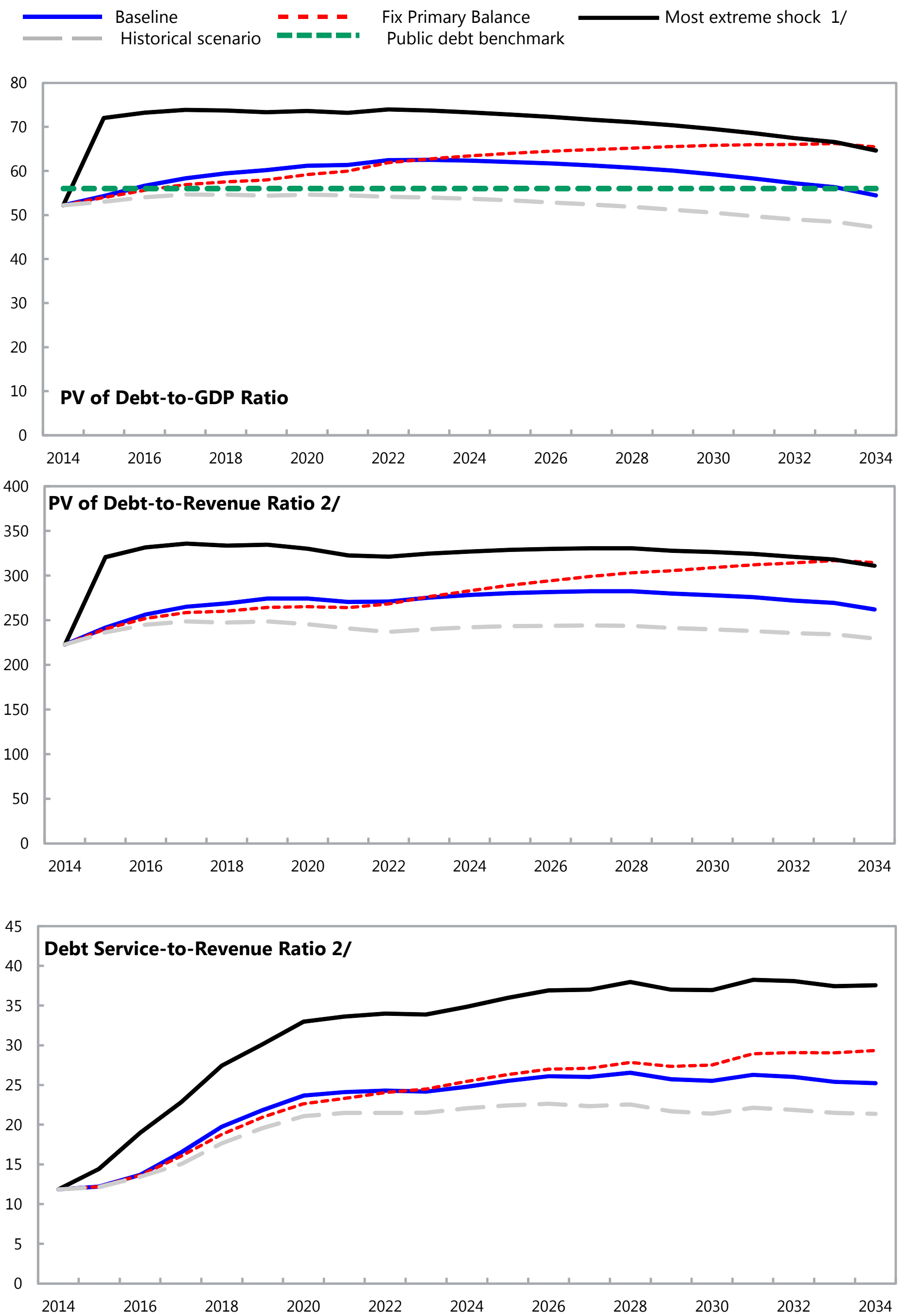
(Probability Approach)



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a One-time depreciation shock; in c. to a Non-debt flows shock; in d. to a One-time depreciation shock; in e. to a Non-debt flows shock and in figure f. to a One-time depreciation shock

Figure 3. Lao P.D.R.: Indicators of Public Debt Under Alternative Scenarios 2014–34 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024.

2/ Revenues are defined inclusive of grants.

Table 1. Lao P.D.R.: External Debt Sustainability Framework, Baseline Scenario, 2011–34 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Projections									
	2011	2012	2013			2014	2015	2016	2017	2018	2019	2014-2019 Average	2024	2034	2020-2034 Average
External debt (nominal) 1/	**76.5**	**79.8**	**84.4**			**90.8**	**91.2**	**87.8**	**83.7**	**78.3**	**73.4**		**60.3**	**47.6**	
of which: public and publicly guaranteed (PPG)	46.7	47.7	48.3			48.5	48.7	47.9	46.9	45.5	44.1		40.5	30.8	
Change in external debt	0.4	3.3	4.6			6.5	0.4	-3.4	-4.1	-5.4	-4.9		-1.9	-1.4	
Identified net debt-creating flows	-1.4	13.3	12.4			13.5	5.3	0.6	-2.2	-3.0	-2.2		-1.6	-1.7	
Non-interest current account deficit	**16.3**	**29.0**	**27.6**	**18.7**	**5.9**	**23.8**	**20.1**	**15.0**	**14.9**	**14.8**	**14.0**		**9.8**	**5.0**	8.1
Deficit in balance of goods and services	16.0	29.6	29.2			26.6	22.1	17.0	17.8	17.7	16.1		11.6	8.5	
Exports	45.5	41.5	43.2			42.2	42.0	43.6	42.9	42.4	41.4		40.2	40.1	
Imports	61.5	71.1	72.5			68.8	64.1	60.6	60.7	60.1	57.5		51.8	48.6	
Net current transfers (negative = inflow)	-2.8	-2.7	-2.2	-2.7	0.4	-3.1	-3.1	-3.1	-3.9	-3.8	-3.3		-3.2	-5.0	-3.6
of which: official	-1.9	-1.8	-1.4			-1.6	-1.6	-1.6	-2.3	-2.2	-1.6		-1.0	-0.3	
Other current account flows (negative = net inflow)	3.1	2.1	0.6			0.3	1.1	1.1	1.0	1.0	1.2		1.3	1.5	
Net FDI (negative = inflow)	**-7.2**	**-6.0**	**-6.3**	**-5.5**	**3.2**	**-5.8**	**-10.1**	**-10.5**	**-13.4**	**-14.7**	**-13.3**		**-9.5**	**-5.3**	-8.9
Endogenous debt dynamics 2/	**-10.5**	**-9.7**	**-9.0**			**-4.5**	**-4.7**	**-3.8**	**-3.7**	**-3.2**	**-2.9**		**-1.8**	**-1.5**	
Contribution from nominal interest rate	1.0	1.2	1.3			1.3	1.2	2.6	2.5	2.4	2.4		2.0	1.4	
Contribution from real GDP growth	-5.2	-5.2	-5.5			-5.8	-6.0	-6.4	-6.2	-5.6	-5.3		-3.8	-2.9	
Contribution from price and exchange rate changes	-6.3	-5.7	-4.7			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**1.8**	**-10.0**	**-7.9**			**-7.0**	**-4.9**	**-4.1**	**-1.9**	**-2.3**	**-2.7**		**-0.4**	**0.4**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	75.8			83.5	84.7	81.9	78.2	73.0	68.1		54.0	41.1	
In percent of exports	...	...	175.3			197.7	201.7	187.7	182.3	172.3	164.4		134.6	102.6	
PV of PPG external debt	**...**	**...**	**39.8**			**41.2**	**42.2**	**42.1**	**41.4**	**40.2**	**38.8**		**34.3**	**24.3**	
In percent of exports	**...**	**...**	**92.0**			**97.6**	**100.5**	**96.4**	**96.5**	**94.9**	**93.6**		**85.3**	**60.7**	
In percent of government revenues	**...**	**...**	**221.3**			**225.4**	**237.0**	**236.5**	**230.2**	**219.2**	**210.2**		**173.3**	**124.1**	
Debt service-to-exports ratio (in percent)	**8.2**	**9.3**	**10.7**			**10.2**	**9.7**	**15.6**	**16.2**	**16.8**	**17.0**		**14.8**	**10.6**	
PPG debt service-to-exports ratio (in percent)	**2.7**	**4.1**	**5.1**			**4.8**	**5.2**	**5.9**	**6.5**	**7.5**	**8.1**		**9.0**	**7.6**	
PPG debt service-to-revenue ratio (in percent)	**7.4**	**9.8**	**12.4**			**11.2**	**12.3**	**14.4**	**15.5**	**17.4**	**18.1**		**18.3**	**15.5**	
Total gross financing need (Billions of U.S. dollars)	1.0	2.5	2.8			2.6	1.8	1.6	1.3	1.2	1.4		1.7	2.3	
Non-interest current account deficit that stabilizes debt ratio	15.9	25.7	23.1			17.3	19.7	18.4	19.0	20.2	18.9		11.7	6.4	
Key macroeconomic assumptions															
Real GDP growth (in percent)	8.0	7.9	8.0	7.8	0.5	7.4	7.2	7.7	7.7	7.4	7.5	7.5	6.6	6.3	6.3
GDP deflator in US dollar terms (change in percent)	9.1	8.1	6.3	9.8	6.0	0.5	2.6	1.3	1.4	2.4	3.2	1.9	1.4	1.3	1.4
Effective interest rate (percent) 5/	1.5	1.8	1.9	1.7	0.3	1.6	1.5	3.1	3.1	3.2	3.4	2.6	3.5	3.1	3.4
Growth of exports of G&S (US dollar terms, in percent)	35.6	6.3	19.6	23.3	17.5	5.4	9.4	13.3	7.4	8.6	8.5	8.8	8.1	8.0	7.5
Growth of imports of G&S (US dollar terms, in percent)	29.2	34.8	17.0	25.4	9.6	2.5	2.4	3.2	9.4	8.8	6.2	5.4	6.9	7.1	6.6
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	9.9	13.2	14.7	15.5	16.2	16.0	14.3	12.6	9.0	11.6
Government revenues (excluding grants, in percent of GDP)	16.6	17.2	18.0			18.3	17.8	17.8	18.0	18.3	18.4		19.8	19.6	19.7
Aid flows (in Billions of US dollars) 7/	0.5	0.6	0.6			0.7	0.7	0.7	0.8	0.8	0.9		0.9	0.8	
of which: Grants	0.5	0.6	0.6			0.6	0.6	0.6	0.6	0.6	0.6		0.7	0.7	
of which: Concessional loans	0.0	0.0	0.0			0.1	0.1	0.1	0.2	0.2	0.2		0.2	0.1	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			5.7	5.4	4.9	4.7	4.5	4.2		3.2	1.5	2.6
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			53.1	53.7	56.3	55.7	53.1	51.2		47.0	35.1	42.5
Memorandum items:															
Nominal GDP (Billions of US dollars)	8.1	9.4	10.8			11.6	12.8	14.0	15.2	16.8	18.6		27.0	57.1	
Nominal dollar GDP growth	17.8	16.6	14.8			7.9	10.0	9.1	9.2	10.0	10.9	9.5	8.1	7.8	7.8
PV of PPG external debt (in Billions of US dollars)			4.2			4.8	5.3	5.7	6.2	6.6	7.1		9.1	13.6	
(PVt-PVt-1)/GDPt-1 (in percent)						**5.2**	4.7	3.5	3.1	2.9	2.8	3.7	1.7	0.9	1.4
Gross workers' remittances (Billions of US dollars)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of PPG external debt (in percent of GDP + remittances)	...	...	39.8			41.2	42.2	42.1	41.4	40.2	38.8		34.3	24.3	
PV of PPG external debt (in percent of exports + remittances)	...	...	92.0			97.6	100.5	96.4	96.5	94.9	93.6		85.3	60.7	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	5.1			4.8	5.2	5.9	6.5	7.5	8.1		9.0	7.6	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

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

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

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

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

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

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

Table 2. Lao P.D.R.: Public Sector Debt Sustainability Framework, Baseline Scenario, 2011–34

(In percent of GDP, unless otherwise indicated)

	Actual					Estimate				Projections					
	2011	2012	2013	Average 5/	Standard Deviation 5/	2014	2015	2016	2017	2018	2019	2014-19 Average	2024	2034	2020-34 Average
Public sector debt 1/	58.0	59.4	59.1			59.6	60.8	62.5	63.8	64.8	65.5		68.6	61.0	
of which: foreign-currency denominated	46.7	47.7	48.3			48.5	48.7	47.9	46.9	45.5	44.1		40.5	30.8	
Change in public sector debt	-0.3	1.5	-0.3			0.5	1.2	1.8	1.3	1.0	0.7		-0.1	-1.9	
Identified debt-creating flows	-6.2	-6.4	-1.1			-1.0	-0.6	0.1	-0.2	-0.3	-0.5		-1.0	-1.5	
Primary deficit	1.1	1.1	3.9	1.8	1.1	2.8	3.2	3.8	3.5	3.6	3.4	3.4	1.5	0.5	1.3
Revenue and grants	22.6	23.3	23.4			23.4	22.5	22.1	22.0	22.1	21.9		22.4	20.8	
of which: grants	6.0	6.0	5.5			5.2	4.7	4.3	4.0	3.8	3.5		2.6	1.2	
Primary (noninterest) expenditure	23.7	24.4	27.3			26.2	25.7	25.9	25.5	25.7	25.4		23.9	21.3	
Automatic debt dynamics	-7.3	-7.6	-5.0			-3.8	-3.8	-3.7	-3.7	-3.9	-4.0		-2.5	-2.0	
Contribution from interest rate/growth differential	-5.4	-5.0	-4.2			-3.6	-3.9	-4.1	-4.0	-3.6	-3.5		-2.7	-2.2	
of which: contribution from average real interest rate	-1.1	-0.7	0.2			0.4	0.1	0.2	0.5	0.8	1.0		1.6	1.5	
of which: contribution from real GDP growth	-4.3	-4.2	-4.4			-4.1	-4.0	-4.3	-4.5	-4.4	-4.5		-4.3	-3.7	
Contribution from real exchange rate depreciation	-1.9	-2.6	-0.8			-0.2	0.1	0.4	0.3	-0.3	-0.5		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	6.0	7.9	0.8			1.5	1.8	1.7	1.4	1.3	1.3		0.8	-0.4	
Other Sustainability Indicators															
PV of public sector debt	...	...	50.5			52.2	54.3	56.6	58.3	59.4	60.2		62.3	54.5	
of which: foreign-currency denominated	...	...	39.8			41.2	42.2	42.1	41.4	40.2	38.8		34.3	24.3	
of which: external	...	...	39.8			41.2	42.2	42.1	41.4	40.2	38.8		34.3	24.3	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	3.8	6.0	12.8			9.0	9.4	10.4	11.4	12.7	13.5		14.5	14.2	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	215.6			222.7	241.7	256.6	265.2	268.9	274.4		278.2	262.0	
PV of public sector debt-to-revenue ratio (in percent)	...	...	281.3			285.8	304.9	318.4	324.3	323.9	326.1		315.5	278.1	
of which: external 3/	...	...	221.3			225.4	237.0	236.5	230.2	219.2	210.2		173.3	124.1	
Debt service-to-revenue and grants ratio (in percent) 4/	5.9	8.3	11.7			11.8	12.2	13.7	16.5	19.7	21.8		24.8	25.2	
Debt service-to-revenue ratio (in percent) 4/	8.1	11.2	15.3			15.2	15.4	17.0	20.2	23.8	26.0		28.1	26.8	
Primary deficit that stabilizes the debt-to-GDP ratio	1.3	-0.3	4.2			2.3	2.0	2.0	2.3	2.6	2.7		1.6	2.4	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	8.0	7.9	8.0	7.8	0.5	7.4	7.2	7.7	7.7	7.4	7.5	7.5	6.6	6.3	6.3
Average nominal interest rate on forex debt (in percent)	0.5	1.3	1.8	1.1	0.4	1.8	2.0	2.6	2.9	3.5	3.8	2.8	4.3	4.5	4.4
Average real interest rate on domestic debt (in percent)	-4.5	-5.0	0.9	-3.0	4.6	3.6	0.3	-1.1	0.7	1.2	1.6	1.1	2.8	2.8	2.8
Real exchange rate depreciation (in percent, + indicates depreciation)	-4.4	-6.0	-1.9	-6.4	7.1	-0.3	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	6.0	7.7	4.1	6.6	4.9	3.9	5.5	5.5	5.9	6.6	7.0	5.7	5.1	5.1	5.1
Growth of real primary spending (deflated by GDP deflator, in percent)	5.3	11.0	20.9	3.8	7.0	3.1	5.0	8.5	6.3	8.2	6.1	6.2	5.0	5.6	5.1
Grant element of new external borrowing (in percent)	...	...	...	...	...	9.9	13.2	14.7	15.5	16.2	16.0	14.3	12.6	9.0	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

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

3/ Revenues excluding grants.

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

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

Table 3. Lao P.D.R.: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–34

(In percent)

	Projections							
	2014	2015	2016	2017	2018	2019	**2024**	2034
PV of debt-to GDP ratio								
Baseline	41	42	42	41	40	39	**34**	24
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	41	42	44	48	51	54	**65**	66
A2. New public sector loans on less favorable terms in 2014-2034 2	41	41	41	40	39	38	**33**	23
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	41	41	41	41	40	38	**34**	24
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	41	42	45	44	43	41	**35**	24
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	41	41	40	39	38	37	**32**	23
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	41	47	52	51	49	47	**40**	25
B5. Combination of B1-B4 using one-half standard deviation shocks	41	42	42	42	40	39	**33**	22
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	41	59	58	57	56	54	**47**	34
PV of debt-to-exports ratio								
Baseline	98	100	96	96	95	94	**85**	61
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	98	99	101	111	121	130	**162**	164
A2. New public sector loans on less favorable terms in 2014-2034 2	98	98	94	94	93	91	**83**	58
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	98	99	94	94	93	92	**83**	59
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	98	104	113	113	111	110	**98**	66
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	98	99	94	94	93	92	**83**	59
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	98	112	120	119	117	115	**99**	62
B5. Combination of B1-B4 using one-half standard deviation shocks	98	101	101	100	99	97	**86**	57
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	98	99	94	94	93	92	**83**	59
PV of debt-to-revenue ratio								
Baseline	225	237	236	230	219	210	**173**	124
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	225	234	248	265	279	293	**329**	336
A2. New public sector loans on less favorable terms in 2014-2034 2	225	232	230	223	214	205	**169**	119
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	225	233	232	226	216	207	**170**	122
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	225	238	251	244	232	222	**180**	123
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	225	230	223	217	207	199	**164**	117
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	225	264	294	284	270	257	**200**	126
B5. Combination of B1-B4 using one-half standard deviation shocks	225	238	238	231	220	210	**168**	113
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	225	329	327	318	304	291	**240**	171

Table 3. Lao P.D.R.: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–34 (concluded)

(In percent)

Debt service-to-exports ratio								
Baseline	5	5	6	7	8	8	**9**	8
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	5	5	5	5	6	6	**7**	8
A2. New public sector loans on less favorable terms in 2014-2034 2	5	5	5	6	7	7	**7**	5
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	5	5	6	7	8	8	**9**	8
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	5	5	7	7	8	9	**11**	9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	5	5	6	7	8	8	**9**	8
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	5	5	6	7	8	8	**11**	8
B5. Combination of B1-B4 using one-half standard deviation shocks	5	5	6	6	7	8	**9**	7
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	5	5	6	7	8	8	**9**	8
Debt service-to-revenue ratio								
Baseline	11	12	14	16	17	18	**18**	16
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	11	11	13	13	14	14	**15**	17
A2. New public sector loans on less favorable terms in 2014-2034 2	11	12	13	14	15	15	**15**	11
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	11	12	14	16	18	18	**18**	16
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	11	12	14	16	18	18	**19**	16
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	11	12	14	15	17	17	**18**	15
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	11	12	15	17	18	19	**22**	17
B5. Combination of B1-B4 using one-half standard deviation shocks	11	12	13	15	16	17	**18**	15
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	11	17	20	22	25	26	**26**	22
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	36	36	36	36	36	36	**36**	36

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly a
an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 4. Lao P.D.R.: Sensitivity Analysis for Key Indicators of Public Debt 2014–34

	Projections							
	2014	2015	2016	2017	2018	2019	2024	2034
PV of Debt-to-GDP Ratio								
Baseline	52	54	57	58	59	60	62	54
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	52	53	54	55	55	54	54	47
A2. Primary balance is unchanged from 2014	52	54	56	57	58	58	63	65
A3. Permanently lower GDP growth 1/	52	54	57	59	60	61	64	58
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	52	54	57	59	60	61	63	55
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	52	54	56	58	59	59	62	54
B3. Combination of B1-B2 using one half standard deviation shocks	52	54	55	57	58	59	61	54
B4. One-time 30 percent real depreciation in 2015	52	72	73	74	74	73	73	65
B5. 10 percent of GDP increase in other debt-creating flows in 2015	52	61	63	64	65	65	66	57
PV of Debt-to-Revenue Ratio 2/								
Baseline	223	242	257	265	269	274	278	262
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	223	236	245	249	247	249	242	229
A2. Primary balance is unchanged from 2014	223	240	252	259	260	264	283	315
A3. Permanently lower GDP growth 1/	223	242	257	266	270	277	284	279
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	223	242	258	267	271	276	281	267
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	223	241	253	261	266	271	276	261
B3. Combination of B1-B2 using one half standard deviation shocks	223	238	249	258	263	268	273	259
B4. One-time 30 percent real depreciation in 2015	223	321	332	336	334	334	327	311
B5. 10 percent of GDP increase in other debt-creating flows in 2015	223	272	287	292	294	298	297	273
Debt Service-to-Revenue Ratio 2/								
Baseline	12	12	14	17	20	22	25	25
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	12	12	13	15	18	20	22	21
A2. Primary balance is unchanged from 2014	12	12	14	16	19	21	25	29
A3. Permanently lower GDP growth 1/	12	12	14	17	20	22	25	27
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	12	12	14	17	20	22	25	26
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	12	12	14	16	19	22	25	25
B3. Combination of B1-B2 using one half standard deviation shocks	12	12	14	16	18	22	24	25
B4. One-time 30 percent real depreciation in 2015	12	14	19	23	27	30	35	38
B5. 10 percent of GDP increase in other debt-creating flows in 2015	12	12	15	25	21	24	27	27

Sources: Country authorities; and staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

December 15, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of October 31, 2014)

Membership Status: Joined on July 5, 1961.

General Resources Account:

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

SDR Department:

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

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

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

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

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/Interest		0.00	0.00	0.00	0.00
Total		0.00	0.00	0.00	0.00

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

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

Exchange Rate Arrangement

The de jure arrangement is floating. The kip slightly depreciated against the U.S. dollar within a 1 percent band from November 2013 to November 2014. Therefore, the de facto arrangement is reclassified retroactively as crawl-like from its previous classification as stabilized. The authorities' objective is to limit currency fluctuations vis-à-vis major currencies, including the U.S. dollar and Thai baht, within ±5 percent per annum. The Bank of the Lao P.D.R. (BOL) sets a daily official reference rate, which is calculated as a weighted average of the previous day's interbank rates. Commercial banks and foreign exchange bureaus are required to maintain their buying and selling rates within ±0.25 percent of the BOL's daily reference rate for the U.S. dollar. For the euro and baht, the buying and selling rates may not exceed a margin of 0.5 percent. For other currencies, a margin of 2 percent applies.

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

Article IV Consultation

The last Article IV consultation discussions were held in Vientiane during August 28–September 12, 2013 and were concluded by the Executive Board on November 15, 2013. The staff report (Country Report No. 13/369) was published on December 20, 2013.

Technical Assistance

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

Resident Representative

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

IMF-WORLD BANK COLLABORATION

The World Bank and the IMF country teams for Lao P.D.R. met on October 21, 2014 to discuss economic issues and outlook and to coordinate the two teams' work for FY2015. The teams were led by Mr. Alain W. D'Hoore (Senior Country Economist, Macro and Fiscal Management Global Practice, World Bank), and Mr. Ashvin Ahuja (IMF Mission Chief for Lao P.D.R.).

The teams agreed that although Lao P.D.R. had made progress on macroeconomic stabilization, significant vulnerabilities remain. While fiscal consolidation has been initiated, more efforts could be made to reduce external vulnerabilities and restore fiscal sustainability. Tighter fiscal and monetary policies, a more flexible exchange rate and strengthened banking supervision will be needed to build international reserves and ensure macro-financial stability. In the longer run, a key challenge is to promote inclusive growth and poverty reduction through more diversification into nonresource sectors and sustainable development of natural resources. Much progress has been made in recent years on product and labor market openness and poverty reduction. Further trade integration will improve the business climate, and promote private investment and institutional reform. Upgrading health and education infrastructure will raise the growth potential and help reduce inequality.

Lao P.D.R.: Bank and Fund Planned Activities in Macro-Critical Structural Reform Areas, October 2013–April 2015

Title	Products	Provisional Timing of Missions	Delivery Date
1.World Bank Program	Poverty Reduction Support Operations (PRSOs)	Third series (10th Operation is under preparation with Identification mission in September 2014)	Implementation throughout fiscal year. PRSO 10 Board discussion expected in FY16
	Customs and Trade Facilitation Project (CTFP) and Lao PDR second Trade Development Facility project (TDF II)	November 2014	Implementation throughout fiscal year TDF2 effective in May 2013
	Hydro-Mining Technical Assistance Project	Ongoing	Additional Financing approved in June 2014. Implementation throughout FY15
	Technical Assistance on improving financial soundness indicators	Ongoing	Implementation throughout FY15
	Lao Statistical Capacity Building Project (LAOSTAT) (focus on economic statistics and macro framework in coordination with IMF TA below)	Ongoing	Implementation throughout FY15
	Analytical work: macroeconomic monitoring (Lao economic monitors), investment climate	Ongoing	Implementation throughout FY15
	Lao Development Report (on human resource development and skills)	Completed	October 2014

Title	Products	Provisional Timing of Missions	Delivery Date
2. IMF Work Program	Periodic staff visits by IMF HQ team and resident representative based in Hanoi	July 2014	June 2015
	Technical Assistance mission on natural resource revenue administration	Completed	December 2013
	Technical Assistance mission on tax administration	Completed	January 2014
	Technical Assistance on bank-supervision and regulations	Completed	December 2013; November, 2014
	Technical Assistance on consumer prices/producer prices	Completed	February 2014
	Technical Assistance on national accounts statistics	Completed	March 2014
	Technical Assistance on monetary policy implementation	Ongoing	Implementation throughout FY15
	Technical Assistance on crisis management	Completed	June 2014
	Article IV Consultation	October 2014	Board discussion January 2015
	TAOLAM assistance on external sector statistics compilation	Regular staff visits	Implementation throughout FY15
	TAOLAM assistance on strengthening fiscal reporting, Government Finance Statistics (GFS)	Regular staff visits	Implementation throughout FY15
	TAOLAM on public financial management - implementation of the cash-based IPSAS	Regular staff visits	Implementation throughout FY15
	TAOLAM on macroeconomic framework	Regular staff visits which started in October 2013.	Implementation throughout FY15
3. Joint Work Program	External Debt Sustainability Analysis	October 2014	November 2014

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

The Asian Development Bank's (AsDB) current Country Partnership Strategy (CPS) 2012-2016 is aligned with the government's Seventh Five-Year National Socio-Economic Development Plan, 2011–2015. It promotes inclusive and sustainable growth and poverty reduction through (i) engagement in four priority sectors (agriculture, natural resources and rural development; education; energy; and water and other urban infrastructure and services); and (ii) more effective private sector development, gender equity, public sector management and regional cooperation and integration as crosscutting concerns. The CPS aims to maximize efficiency and sustainability through larger operations implemented over a longer period; maximize synergies with the implementation of Greater Mekong Subregion (GMS) strategic framework 2012–22; and also increase responsiveness to emerging issues in a rapidly changing economy. The performance-based allocation of the Asian Development Fund (ADF), based on the country performance assessment (CPA) finalized in 2012, provided Lao P.D.R. with an ADF allocation in the amount of US$156.01 million for the biennial period 2013–14. The CPA for the next allocation period (2015–16) will be finalized by the end of 2014.

As of end-2013, outstanding loans/grants approved stood at US$715.0 million, of which amount of US$368.3 million was awarded for contracts. During 2013, US$76.4 million was disbursed and US$102.6 million of contracts were awarded. ADB approved three new loan projects and four new technical assistance (TA) projects for a total of US$115 million and US$2.5 million in 2013 respectively, including water supply and sanitation, GMS rural infrastructure development and private sector development program; TA projects related to health and road sector governance, smallholder, and support for improved aid effectiveness.

Lao P.D.R.: Asian Development Bank Commitments and Disbursements, 2003–13 1/
(In millions of U.S. dollars)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013 2/
Commitments	34.9	54.8	87	60.7	47.4	46.6	81.2	55.3	53.2	73.65	102.6
Disbursements	54.7	48.5	78.7	76.8	74.8	56.9	75.9	61.5	73.2	68.6	76.4

Source: Data provided by the Asian Development Bank.

1/ Starting from 2006, the commitments and disbursements included both loans and grants.
2/ The commitments and disbursements were estimated for 2013.

STATISTICAL ISSUES

LAO PEOPLE'S DEMOCRATIC REPUBLIC—STATISTICAL ISSUES APPENDIX As of December 3, 2014
I. Assessment of Data Adequacy for Surveillance
General: Data provision has serious shortcomings that significantly hamper surveillance, especially regarding national accounts, government finance, monetary and financial and external sector statistics. These shortcomings are mostly due to lack of capacity, which could be addressed through further efforts on the part of the agencies involved. The IMF is conducting technical assistance (TA) and training programs to address the specific needs with a focus to mitigate near-term risks, covering the areas of national accounts, prices, government finance statistics, monetary and financial statistics, and external sector statistics.
National Accounts: National accounts (NA) comprise annual estimates of GDP by activity at current and constant prices (base year=2002), broadly following the *System of National Accounts (SNA) 1993*. Lao P.D.R. participated in the IMF's Statistics Department (STA) project to implement the SNA and International Comparison Project (ICP), funded by the government of Japan through the Japan Administered Account for Selected Activities (JSA), and has received technical assistance (TA) to improve annual national accounts and develop quarterly national accounts (QNA). Under this project, Lao PDR made some methodology improvements in the annual GDP by activity estimates, including good progress in updating the base year from 2002 to 2010, and has moved closer to completing a new annual expenditure measure of GDP and a preliminary GNI series, Some progress had also been made toward the development of a new quarterly GDP series. Under a new JSA funding Project, a Real Sector Statistics Advisor for Lao P.D.R. and Bangladesh, stationed in the latter country, was appointed in January 2014 to assist with the improvement of national accounts.
Price Statistics: Lao P.D.R. compiles a monthly CPI (December 2010=100) using weights based on the 2007/08 Lao Expenditure and Consumption Survey. An update on the weights is expected for this year to be implemented in 2016 CPI collection. A producer price index (PPI) is under development and is planned for availability in March 2015. Data from the 2012 economic census will be used to develop its weights and as the basis for selecting a sample of establishments. The PPI coverage is currently restricted to mining and quarrying, manufacturing, and electricity and will be progressively expanded to cover tourism, construction activities, agriculture, services and other activities.
Government Finance Statistics: Government finance statistics remain weak. The timeliness of fiscal reporting needs significant improvement. Off-budget activities are not included in the fiscal data, although they have expanded rapidly in recent years. Annual budget and outturn data formats do not follow international standards for government finance statistics. Except for the annual data disseminated in the Official Gazette, no fiscal data are disseminated in the country. A mission took place during March 2014 funded by the Government of Japan through the Japan Administered Account for Selected IMF activities (JSA) to further assist the Fiscal Policy Department (FPD) of the Ministry of Finance (MoF) in upgrading the compilation and dissemination procedures of GFS data for Lao P.D.R. in line with the ongoing migration to the GFSM 2001. The JSA has also financed a resident advisor to assist and guide the updating and implementing of the GFSM 2001 (GFSM 2014) migration action plans by providing training on GFS, by promoting interaction of government

agencies in the development of GFS, and by coordinating the GFS reporting with other fiscal reporting activities. The authorities will be assisted in disseminating GFS data on their websites and reporting the data for publication.

Monetary and Financial Statistics: The classification of monetary data by institutional sector and by financial instrument as well as valuation principles need to be strengthened. The latest monetary data reported to STA refer to December 2010. The Standardized Report Forms (SRFs), which embody the IMF-recommended framework for compiling monetary statistics, have yet to be introduced. STA conducted a one-week training course for the Bank of Lao in February 2014, to build the capacity of the monetary compilers.

Financial sector surveillance: Financial sector surveillance: Lao P.D.R. does not produce Financial Soundness Indicators (FSIs) yet.

External sector statistics: STA appointed an External Sector Statistics (ESS) Advisor to the Technical Assistance Office for Lao P.D.R. and Myanmar (TAOLAM) in February 2014. Since then, the Advisor has conducted three missions, which focused mainly on trade. The missions assisted in reconciling the discrepancy between imports data published by the Bank of Lao and imports derived from partner countries' data in the Direction of Trade Statistics and found that the use of minimum prices to value vehicles and petroleum imports might explain some of the differences. In addition, several balance of payments components are missing due to the lack of source data. The BOL balance of payments compilers have designed an FDI survey questionnaire in the context of the World Bank's LAOSTAT-Strengthening the National Statistical System Project. Coordination on FDI is needed as the European Union has also appointed an expert to assist on FDI statistics. Implementation of the new international transactions reporting system (ITRS) is ongoing and testing of the new ITRS is expected by June 2015. The BOL does not yet compile an international investment position statement.

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

Table of Common Indicators Required for Surveillance

As of November 26, 2014

	Date of Latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]
Exchange Rates	11/25/14	11/25/14	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	August 2014	10/21/14	M	I	Q
Reserve/Base Money	August 2014	10/21/14	M	I	Q
Broad Money	August 2014	10/21/14	M	I	Q
Central Bank Balance Sheet	August 2013	10/21/14	M	I	Q
Consolidated Balance Sheet of the Banking System	August 2013	10/21/14	M	I	Q
Interest Rates[3]	September 2014	10/21/14	M	M	M
Consumer Price Index	October 2014	11/02/14	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4]—General Government[5]	September 2014	10/21/14	I	I	I
Revenue, Expenditure, Balance and Composition of Financing[4]—Central Government	September 2014	10/21/14	Q	I	M
Stocks of Central Government and Central Government-Guaranteed Debt[6]	December 2013	10/21/14	NA	NA	NA
External Current Account Balance	Q2 2014	10/21/14	Q	I	I
Exports and Imports of Goods and Services	Q2 2014	10/21/14	Q	I	I
GDP/GNP	2012/13	10/21/14	A	A	A
Gross External Debt	Dec 2013	10/21/14	A	A	I
International Investment Position[7]			NA	NA	NA

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

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

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

4 Foreign and domestic bank, nonbank financing.

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

6 Including currency and maturity composition.

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

Statement by the Staff Representative on Lao People's Democratic Republic
January 14, 2015

1. This statement provides information that has become available since the staff report was circulated to the Executive Board on December 17, 2014. This information does not alter the thrust of the staff appraisal.

2. Real GDP growth was 7.8 percent (y/y) in fiscal year 2014 (October 2013–September 2014). For calendar year 2014, growth is estimated at around 7½ percent, broadly in line with staff's forecast.

3. Inflation edged down slightly on a year-on-year basis to 2.8 percent in November (3.0 percent in October), reflecting slowing nonfood price increases and lower energy prices. Inflation in 2014 is likely to be slightly lower than staff's forecast.

Press Release No. 15/78
FOR IMMEDIATE RELEASE
February 26, 2015

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

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

On January 14, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Lao People's Democratic Republic.

Real GDP growth is expected to moderate from 8 percent in 2013 to 7½ percent in 2014. Domestic activity has slowed, and credit growth has declined from excessive levels. Inflation has declined to 3 percent from 6½ percent at end-2013, largely due to weaker food and fuel price momentum. However, the current account deficit is expected to remain large at 25 percent of GDP in 2014; and, at 1 month of prospective imports of goods and services, international reserves (US$0.7 billion, August 2014) do not offer adequate protection against external shocks. Bank balance sheets are showing signs of weakness, with rising nonperforming loans (NPL) and weaker capital and profitability. Public and publicly guaranteed debt (excluding arrears) is projected at 60 percent of GDP in nominal terms (52 percent of GDP in present value terms) in 2014.

As growth continues to moderate in the near term, inflation is projected to remain in the mid-single digits. The current account deficit is projected to improve to about 21 percent of GDP in 2015, but with lower capital inflows, reserves would rise only slightly to 1¼ months of imports. Risks are on the downside. A more expansionary fiscal stance would worsen the external position. The economy is also exposed to external shocks, notably a regional growth slowdown and a deterioration in terms-of-trade and capital inflows. With a thin reserves cushion, these shocks could force large movements in the exchange rate, leading to debt defaults, and undermining growth, financial stability, and fiscal sustainability.

Following a sharply expansionary and procyclical stance in 2013, the authorities started to tighten fiscal policy in 2014, mainly through curbs on civil service compensation and capital spending cuts. Public investment cuts have helped limit the Bank of Lao P.D.R.'s quasi-fiscal lending and lower private credit growth. Strict enforcement of regulation on banks' net open foreign exchange positions and the limits on foreign-currency lending has helped reduce foreign-

[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.

currency liquidity risk at banks. However, excess kip liquidity in the banking system has risen, and greater exchange rate flexibility, observed in the second half of 2013, has not resumed.

After years of rapid credit growth, financial stability concerns are coming to the fore. Accumulation of public investment arrears has led to losses in the business sector, with impact on banks. The system's nonperforming loan ratio (NPL) is estimated to have doubled during the first half of 2014. In the same period, state-owned banks' average NPL is reported to have increased from 2 percent to about 8 percent, with average capital-to-asset ratio declining to 3 percent. Direct exposure to foreign currency through lending and deposits remain high, with the foreign-currency shares in total lending and deposits standing at 48 percent, down from 50 percent in 2013.

Executive Board Assessment[2]

The Executive Directors welcomed policy corrections initiated by the Lao P.D.R. authorities and the progress made in macroeconomic stabilization in the past year. Directors nevertheless noted that the economic outlook remains clouded by significant vulnerabilities in the external, fiscal, and financial sectors. A regional growth slowdown, deterioration in global metal prices, and capital flow volatility continue to pose external risks. To address these vulnerabilities, Directors emphasized the need for continued fiscal consolidation, greater exchange rate flexibility, tighter monetary conditions, strengthened financial supervision, and improved bank resolution and crisis prevention frameworks.

Directors considered that a more ambitious medium-term fiscal consolidation anchored around a nonmining deficit target of no more than 5 percent of GDP would help strengthen the external position and reduce public debt. While welcoming recent progress in fiscal consolidation, Directors stressed the need to ensure steady consolidation into the medium term and create space for well-targeted social and capital spending and possible banking sector contingent liabilities. In this regard, they recommended further revenue mobilization, the rationalization of current and off-budget capital expenditures, and containing public sector employee compensation, including by accelerating civil service reform. Directors also encouraged enhanced fiscal transparency and strengthened public financial management, including the elimination of fiscal arrears.

Directors recommended letting the exchange rate move more flexibly within the official band, supported by the tightening of kip liquidity, with interventions limited to preventing excessive exchange rate volatility. They noted that this approach would avoid a potentially destabilizing devaluation, given the risk from currency mismatches; help contain inflation; and support interbank market functioning.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors welcomed measures to improve foreign currency liquidity at banks, but noted increasing financial stability concerns from growing credit impairment and undercapitalization at state-owned banks. They recommended prompt recognition of nonperforming loans, the phasing out of regulatory forbearance, strengthening supervisory and lending practices, and recapitalizing state-owned banks to help safeguard macro-financial stability. Technical and capacity-building assistance from the Fund would be helpful in this regard. Directors welcomed the passage of the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) law, and advised full implementation of the action plan agreed with the Financial Action Task Force.

Directors emphasized the need for more resources to enhance the quality, availability, coverage, and publication of economic and financial data, and encouraged the authorities to request further Fund technical assistance in this regard.

Directors welcomed progress on product and labor market openness and gains in poverty reduction. To support more inclusive and broad-based growth, they recommended further trade integration and improvements in education and health infrastructure. Directors noted that the benefits of financial deepening and financial access by small and medium-sized enterprises could be enhanced through the adoption of a clear and unified accounting framework; strengthened creditors' rights, credit analysis, and financial transparency; and implementation of an effective debt resolution process.

Lao P.D.R.: Selected Economic and Financial Indicators, 2010–15[1/]

	2010	2011	2012	2013	2014	2015
				Est.	Proj.	
GDP and prices (percentage change)						
Real GDP growth	8.1	8.0	7.9	8.0	7.4	7.2
CPI (annual average)	6.0	7.6	4.3	6.4	4.3	5.0
CPI (end year)	5.8	7.7	4.7	6.6	3.6	5.6
Public finances (in percent of GDP)						
Revenue and Grants	22.6	22.4	24.1	23.9	23.6	22.5
Of which: Resources	2.6	3.4	3.9	3.0	2.8	2.3
Of which: Mining	1.8	2.5	3.2	2.2	2.0	1.6
Of which: Hydro power	0.8	0.9	0.7	0.8	0.7	0.8
Of which: Grant	6.7	6.0	6.4	5.7	5.3	4.8
Expenditure	25.9	24.1	24.6	29.6	27.9	27.2
Expense	11.2	11.3	12.0	17.3	15.5	16.2
Net acquisition of nonfinancial assets 2/	14.6	12.9	12.6	12.3	12.3	10.9
Overall balance	-3.2	-1.7	-0.5	-5.6	-4.2	-4.7
Nonmining balance 3/	-5.0	-4.3	-3.7	-7.8	-6.3	-6.2
Money and credit (annual percent change)						
Reserve money	48.6	16.2	27.2	7.7	22.6	20.8
Broad money	39.5	28.7	31.0	17.0	16.6	23.7
Bank credit to the economy 4/	48.4	45.8	26.6	34.5	15.7	23.8
Bank credit to the private sector	48.4	39.3	35.1	36.3	14.0	24.0
Balance of payments						
Exports (in millions of U.S. dollars)	2,196	3,120	3,323	3,882	4,119	4,498
In percent change	44.4	42.1	6.5	16.8	6.1	9.2
Imports (in millions of U.S. dollars)	3,574	4,635	6,340	7,283	7,604	7,756
In percent change	23.6	29.7	36.8	14.9	4.4	2.0
Current account balance (in millions of U.S. dollars)	-1,369	-1,393	-2,838	-3,123	-2,913	-2,726
In percent of GDP	-20.0	-17.3	-30.2	-28.9	-25.0	-21.3
Gross official reserves (in millions of U.S. dollars)	728	677	740	662	750	870
In months of prospective goods and services imports	1.8	1.2	1.1	1.0	1.1	1.2
External public debt and debt service						
External PPG debt						
In millions of U.S. dollars	3,348	3,769	4,500	5,092	5,601	6,118
In percent of GDP	48.1	46.7	47.7	48.3	48.5	48.7
External PPG debt service						
In percent of exports	4.3	2.6	4.0	5.1	4.8	5.2
Exchange rate						
Official exchange rate (kip per U.S. dollar; end-of-period)	8,066	8,019	7,982	8,030	…	…
Real effective exchange rate (2005=100)	125.4	128.3	133.8	141.7	…	…
Nominal GDP						
In billions of kip	56,523	64,727	75,251	84,572	94,340	106,655
In millions of U.S. dollars	6,842	8,062	9,400	10,788	11,642	12,801

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

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

Statement by Mr. Wimboh Santoso, Executive Director for Lao P.D.R. and Mr. Ram Kharel, Advisor to Executive Director

January 14, 2015

Background

1. On behalf of the Lao authorities, we would like to thank the mission team for the constructive policy discussions and invaluable advices provided during the 2014 Article IV consultation. As the country's seventh five-year National Social and Economic Development Plan (7th NSEDP, 2011-15) will end this year, the policy discussion remains extremely useful not only to strengthen macroeconomic stability, but also to frame a new plan so as to overcome remaining obstacles to achieve the 2015 MDG targets and graduate the country from the LDC status by 2020 (Vision 2020).

2. The staff appreciates the authorities' effort of maintaining strong growth over the years while preserving macroeconomic stability. They also outline economic challenges and risks facing the country and the appropriate policy measures to be considered in the report. Our authorities broadly agree with the major thrust of the staff's appraisal contained in the report and will thoughtfully consider the recommendations therein. In general, they remain committed to pursue structural reforms and enhance business environment so as to foster private and foreign investments. They are also mindful that the broad-based and inclusive growth underpinned by domestic and external macroeconomic stability play important roles in raising general living standards, achieving further progress in poverty reduction and meeting the MDG goals.

Recent Economic Development and Outlook

3. Despite the weaker global growth and external uncertainties, Lao PDR has been able to maintain strong growth since a decade on the back of flourishing mining sector and hydropower projects, attracting large foreign investment inflows. Economic growth, however, has slightly moderated to 7.8 percent in FY 2014, from 8.0 percent in 2013 and 7.9 percent in 2012 on the account of weakening mining sector due mainly to moratorium of new mining projects coupled with declining global metal prices. Fiscal consolidation policies, together with tightening credit expansion, have played important roles to moderate growth in 2014.

4. The economic growth in 2015 is projected at 7.5 percent on the account of increasing industrial and service sector by 9.0 percent and agriculture by 3.0 percent, closed to the staff's projection of 7.2 percent. On the other hand, the CPI inflation had been under control at 2.8 percent in November 2014 from 6.6 percent a year ago, largely due to weaker food and fuel prices momentum. It is expected to moderate at 5.6 percent in 2015.

5. Fiscal consolidation remained a priority in 2014 given stress in foreign exchange reserves and rising public debts. As such, budget deficit declined to 4.2 percent of GDP in 2014 from 5.6 percent of GDP a year ago given the authorities effort of maintain public

spending close to the target and strengthening public revenue. They plan to maintain the budget deficit around at 4.7 percent of GDP in 2015 by mainly containing recurrent expenditure, stepping up efforts in improving tax administration and strengthening public financial management system.

6. Given the BOL's prudent monetary policy with foreign exchange market intervention when necessary, the exchange rate has remained broadly stable in recent years. As such, the Kip has appreciated only by 3.5 percent in nominal effective term and 5.0 percent in real term in 2014 compared to that a year ago. The authorities confirm that the appreciation is broadly in line with the movement of regional currencies and remains flexible within the target band. They have also carefully monitored and observed the phenomenon in the parallel exchange market, which has been traded at a premium over the Bank of the Lao PDR's reference rate since August 2013.

7. Because of authorities' focus on strengthening export together with moderating import growth due to slow down in bank credits, the current account deficit has been gradually decreased from 30.2 percent since 2012. It is expected to come down to 25 percent of GDP in 2014 and further to 21.3 percent of GDP in 2015 respectively. It will help to strengthen the foreign exchange reserve to a more comfortable level in the medium term.

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

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

Fiscal Policy

10. The Lao authorities recognize the importance of fiscal prudence and concur that fiscal consolidation is crucial for preserving macroeconomic stability and public debt sustainability. They are mindful that steps to rebuild fiscal buffers are needed to ensure fiscal sustainability. In this regard, they have adopted expenditure rationalizing measures together with introducing a series of other fiscal measures to address fiscal challenges, initiated by amending value-added tax and accounting laws, revising customs and budget laws, and related rules and regulations.

11. On the expenditure side, curtaining the recurrent expenditure and fostering capital and social expenditure remain key priorities of the authorities. In this regard and given higher rise in wages and salaries than expected in late 2013, they have suspended wage rise in civil services that was initiated earlier and also set quota for new recruitment in public services. They have constituted a high level committee to quantify and resolve arrears and debts related to public infrastructure projects so as to streamlining expenses.

12. On the public investments, the government has streamlined expenditures by avoiding low-priority current expenditures and restrained state infrastructure development projects that are commissioned by local governments, financed by private contractors and repaid by the government upon completion of the projects. The authorities are in the process of reviewing procurement procedures and strengthen project management regulations according to the State Investment Law.

13. On revenue front, the authorities are in the process of mapping out strategies to intensify its revenue collection and widen tax base. Revenue collection has been strengthened by enforcing compliance with investment promotion law regarding tax and duty exemption and VAT deductibles, as well as focusing on large taxpayers and taxes on vehicles, petrol and luxury goods.

14. Over the medium-term, the authorities recognize that challenges remain in securing a more sustainable revenue stream especially from non-resource sectors and enhancing the capacity on public financial management. In this regard, they have undertaken sizable investments to upgrade technology in the tax offices and enhance staff's capabilities so as to strengthen revenue mobilization. They have also recently changed valuation method for automobile, fuel imports and luxury goods from reference price system to an actual transaction price system which, together with effective tax surveillance, is expected to enhance revenue mobilization going forward.

15. The authorities are committed to keep public debt on a sustainable path and target to reduce level of external debts to be less vulnerable to external shocks. The Debt Management and Financial Analysis System (DMFAS) have been rolled out to enhance public debt data recording and strengthen debt management capacity. The Presidential Decree Law on Public Debt Management is also expected to be approved by the Lao National Assembly.

Monetary and Exchange Rate Policies

16. The BOL aims to attain the price and exchange rate stability with setting annual target band for the exchange rates and the reference rates for commercial banks. In doing so, the BOL aims to limit currency fluctuations vis-à-vis major currencies within ±5.0 percent per annum. Commercial banks and foreign exchange bureaus are required to maintain their buying and selling rates within ±0.25 percent of the BOL's daily reference rates for US dollar, within ±0.5 percent for Euro and Thai Baht and within ±2.0 percent for other currencies.

17. The authorities welcome staff's assessment that the BOL's commitment to keep the exchange rates within a reasonably wide and adjustable band has provided an anchor for macro-financial stability. However, they are cautious with the staff's recommendation to tighten monetary conditions given slowdown in credit growth from 34.5 percent of GDP in 2013 to 15.7 percent in 2014 with having relatively low level of inflation.

18. Realizing the importance of safeguards against external uncertainties, the BOL has continued stepping up their efforts to strengthen international reserves. Measures that have been implemented include suspension of foreign currency lending to local governments and state-owned enterprises since last few years, collecting outstanding loans, and intensifying enforcement of foreign currency related regulations. In addition, the authorities are taking steps to enhance the mechanism for regulating foreign exchange transactions to be able to monitor daily trading activities in a more real-time basis.

19. As the current account deficit has been reducing gradually since 2012, the authorities are optimistic in maintaining adequate foreign exchange reserves to cover imports at least for 5 months by the end of 2015. While actual data is not comprehensive, the authorities urge staff to be cautious in using trading partners' export data as proxy for Laos' import, as a significant part of the unrecorded import content is re-exported to other countries. That said, the authorities agreed that there could be scope for exploring the discrepancy in the measurement of imports and enhancing the authorities' data collection system.

Financial Sector

20. Banking sector in Lao PDR remains sound with strong capital base, ample liquidity, andlow level of NPLs. While the credit growth has significantly slowed down in 2014, the BOL is aware of potential risks from rapid credit growth in the past, thus has tightened prudential regulation for banks to closely monitor credit quality and to ensure good quality underwriting standard, especially for banks with NPL ratio of more than 3%. Regulations to control single lending limits to mitigate concentration risk and prohibit connected lending to shareholders, directors and subsidiaries have also been issued.

21. The authorities are in the process of adopting Basel II capital standard with technicalsupport from the WB and the Bank of Thailand. In this context, supervisory capacity and regulatory framework are being strengthened to preserve a safe and sound banking system. These efforts along with ongoing enhancement of the regulatory framework under the ASEAN Banking Integration Framework will help to improve banking capacity and enhance financial stability. More importantly, the AML/CFT law has recently been approved by the National Assembly, which has helped to enable business environment and strengthened public confidence in the banking system.

22. Improving money and capital market remain priority to strengthen transmission mechanism of monetary policy. In this context, our authorities are in the process of creating FX trading monitoring system, promoting active interbank market, and strengthening financial market. They have introduced *End of Day Liquidity Management*

Program (EoDLMP) since May 2014 so as to ensure adequate liquidity in the banking system. Introducing regulations related to the derivative markets are underway.

23. Taking into account of the growing numbers of banking institutions with limited regulatory and supervisory capacity at the BOL, the authorities have temporarily suspended new licenses to private banks until 2016, when the overall performance assessments of the banking sector and craft new licensing policy are completed.

Structural Reform

24. The authorities have made significant progress on structural reforms in recent years where several laws and regulations including those related to AML/CFT, import licensing, custom valuation, investment, technical barriers to trade, as well as intellectual property right have been enacted. The authorities also continue their efforts in simplifying business start-up procedures, notably with the establishment of a one-stop shop to coordinate the application for foreign investment in the country. Electronic data interchange system has been modernized to better facilitate cross-border trades. Our authorities believe that these initiatives will create conducive business climate to more broad-based and inclusive growth.

25. Lao authorities are paying attention to strengthen macroeconomic and financial sector statistics for conducting economic surveillance to formulating appropriate and timely policy responses. Efforts have been made to improve the compliance with international guidelines in official statistics and the reporting system. In this regard, the authorities welcome the Fund's technical assistance to enhance statistical capacity going forward.

Conclusion

26. With the most successful implementation of the 7th national socio-economic plan, our authorities are in the process of crafting new plan to address the remaining bottlenecks in achieving LDC graduation by 2020. The authorities are, however, aware of many challenges ahead and intend to gear up the efforts to embark from the LDC by enhancing business environment, improving efficiency of public services, and reforming public financial management. They also intend to build up necessary fiscal and monetary policy space as well as strengthen banking regulatory and supervisory framework together with enhancing access to financial services.

27. Finally, our authorities welcome constructive policy dialogue with the mission team and wish to thank the Mission Chief, Mr. Ahuja, and his team for the comprehensive reports and useful policy suggestions. On behalf of the authorities, let me also express high appreciation to the Fund for their continuing support to the authorities.