Lao P.D.R.: Assessment Letter for the Asian Development Bank and World Bank
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1. This report provides an update of the assessment of Lao P.D.R.'s macroeconomic conditions and outlook presented at the time of the 2004 Article IV Consultation[1] and in the Assessment Letter of March 10, 2005.

Recent Developments

2. **Lao P.D.R. has continued to enjoy stable macroeconomic conditions and a strong recovery in economic activity**. The Kip traded in a relatively narrow band in the first half of 2005 and the rate of inflation declined to 5½ percent in June, despite a sharp increase in fuel prices. External reserves remained comfortable at around three months of imports, and economic activity is robust, with growth projected to rise to 7¼ percent in 2005, driven by an expansion in mining activity and the construction of the Nam Theun 2 (NT2) hydroelectric dam.

3. **Preliminary data suggest that budget performance weakened in the third quarter of the fiscal year**.[2] Revenue collections through May were running below target, as efforts to improve tax compliance fell short of expectations. While the budget deficit through April was in line with the annual target of 4 percent of GDP, more recent data suggest that the deficit has started to rise, and domestic arrears are also reported to be accumulating. In May, the National Assembly approved a package of tax measures along the lines discussed with the staff, but its implementation will likely be delayed until late August or early September.[3] Although the revenue target for the 2004/05 budget has been reduced to 11.6 percent of GDP, it remains overambitious, and the proposed increase in the wage bill to 4.9 percent of GDP (from 4.3 percent in 2003/04) could put the budget under pressure.

4. **Monetary policy has been more expansionary than expected**. Net domestic assets of the Bank of Lao P.D.R. (BoL) are running above target, mainly because of a drawdown in government deposits. Domestic liquidity, especially currency in circulation, continued to grow more rapidly than programmed—growth in Kip reserve money rose to 40 percent in April

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[1] The 2004 Article IV Consultation was concluded on November 29, 2004.

[2] The fiscal year runs from October to September.

[3] The package included the restoration of a two-rate turnover tax and a rationalization of excise taxes that will result in an increase in the effective rate on some goods (e.g., beer).

(year-on-year)—but there is little evidence, as yet, that this higher-than-expected expansion of liquidity is putting pressure on the Kip or on inflation.

5. **The pace of structural reform remains slow**. On the fiscal side, an improved customs law has been enacted, but progress on more fundamental tax and customs reforms has been limited because of lack of consensus on establishing central control over provincial tax and customs offices. Progress in restructuring the state banks is also slow, and there are concerns that a relaxation of the restrictive lending regime, combined with the recent decision to reduce the number of international banking advisers, might lead to a deterioration in the state banks' financial position.

Economic Outlook

6. **The economic outlook is favorable, provided that progress is made in structural reform**. Economic growth should remain strong during the next few years, with the stimulus from the NT2 project and large mining projects more than offsetting weak garment exports following the expiry of the Multifiber Arrangement (MFA) quota system. The progressive integration of the Lao economy into the region is likely to provide additional stimulus, particularly in the agriculture and tourism sectors. While the current account deficit is projected to increase due to the impact of the large projects, this will be more-than-offset by increased capital inflows—mainly foreign direct investment—and external reserves should remain comfortable at around three months of imports.

7. **However, significant vulnerabilities need to be addressed if the economy is to achieve its potential**. In particular, the fiscal position is fragile, with weak revenue collections and rising spending pressures, notably on wages, putting strains on the budget. Public external debt remains high at 75 percent of GDP, and the budget will have to absorb significant contingent liabilities, notably with respect to the large capital deficiencies of the state banks. Structural reforms need to be accelerated to address these vulnerabilities. Placing the budget on a sound footing, by increasing the revenue effort and strengthening expenditure management, is the top priority. The state bank reform program also needs to be reinvigorated to place these banks on a lasting sound footing.

Key Policy Issues

8. **Steps need to be taken to strengthen the fiscal position**. The priority for the remainder of 2004/05 will be to boost revenue collections through promptly implementing the new revenue measures approved in May, strengthening oversight over the major customs posts, and intensifying efforts to improve compliance by large tax payers. Staff project that, even with these efforts, the 2004/05 revenue will be at 11.2 percent of GDP, or 0.4 percentage points less than the government's current projection. To prevent the deficit from expanding, expenditure restraint is necessary, especially on wages.[4] The authorities have emphasized their

[4] Staff have encouraged the authorities to limit the wage bill, as close as possible to the original proposal of 4.5 percent of GDP.

commitment to avoiding any budget overruns, noting that they hope to contain the expansion of the wage bill, inter alia, by undertaking spot checks of civil servants in the provinces to ensure that provincial wage claims are not overstated. [5]

9. **The 2005/06 budget, which will be presented to the National Assembly in September, provides a further opportunity to consolidate the fiscal position**. The authorities have stressed that the main focus would continue to be on revenue mobilization, in light of the increasing demands to raise spending. Staff concur, but note that it will be critical that the National Assembly approve a sound budget plan based on achievable revenue targets, underpinned by concrete revenue reforms, and a sustainable expansion of expenditure, especially on the wage bill. To this end, the staff have suggested the following parameters for the 2005/06 budget framework, which are being considered by the authorities:

- A revenue target of 11.9 percent of GDP. In addition to reforms to strengthen revenue administration, this will require new tax measures of around 0.3 percent of GDP. [6] Potential measures include further reform of the turnover tax and increases in selected excises (e.g., diesel and tobacco) that have scope for higher rates.

- A ceiling on expenditure of 17 percent of GDP. The main priority will be to contain the wage bill to 4.7 percent GDP, to keep its growth in line with that of domestic revenues. Non-wage recurrent spending should be raised to provide increased resources for priority social spending,[7] and the capital budget should be sufficient to cover the government's counterpart funding commitments and the funding of ongoing projects.

- A budget deficit of about 3½-4 percent of GDP. This target would be consistent with projected donor financing and the need to gradually reduce the debt burden. It would also be consistent with a commitment to avoid bank financing. Given Lao P.D.R.'s high public debt, staff have stressed the importance of prudent debt management, and in particular, urged the authorities to continue to maximize grant financing and borrow only on highly concessional terms.[8]

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[5] The pressure on the wage bill this year is coming mainly from higher employment, following a decision to give provinces greater autonomy over recruitment.

[6] The remainder would come from the full-year effects of the new tax measures approved in May and additional mining royalties and taxes.

[7] Spending on education and health—$10 per capita (combined)—is well below the level needed to make progress toward the Millennium Development Goals.

[8] Jointly with the World Bank, staff will update the Debt Sustainability Analysis for Lao P.D.R. at the time of the 2005 Article IV Consultation.

10. **Monetary policy should be geared to maintaining recent progress in reducing inflation.** Staff have prepared an updated framework for 2005 under which the increase in the BoL's net domestic assets would be progressively reversed over the remainder of the year. In addition to fiscal discipline, continued monetary stability hinges on maintaining tight control over credit growth at the state banks. To this end, the authorities should continue to set ceilings on state banks' net domestic assets, to contain their credit growth to around 10 percent, and expedite progress in strengthening bank regulations, particularly for single borrower exposures.

11. **An acceleration of structural reform in the fiscal area is needed to support fiscal consolidation and provide resources for poverty reduction**. Reforms would be particularly important in the following areas:

- In the revenue area, the key challenge is to centralize authority over the tax and customs administrations. This proposed strategy has three main components: (i) secure a political consensus on the need for a national revenue administration; (ii) integrate provincial tax and customs offices into national organizations; and (iii) launch a concerted capacity building effort to strengthen the tax and customs departments. While the authorities acknowledge the need for further progress on revenue reforms, creating a national revenue administration remains highly sensitive.

- The Customs Department is taking steps to improve its oversight of provincial customs posts, although this remains a challenge. The next steps are to: (i) finalize the regulations for the new Customs law, especially with regard to the role and responsibilities of the national Customs Department; and (ii) strengthen customs operations through the development of post clearance audits and the computerization of customs procedures. A new organizational structure for the department, which includes a third deputy director-general to oversee field operations, should be finalized and approved by the government.

- Progress has been slower in the Tax Department. The authorities should consider integrating the administration of large taxpayers into a single unit under the control and responsibility of the Tax Department.[9] This would also require further progress in strengthening the capacity of the Tax Department. The technical assistance program being supported by SIDA (Sweden) will be critical to these efforts.

- The VAT will need to be delayed until 2008, to ensure adequate preparatory time. The National Assembly will start discussion of the VAT's key parameters in September, but the main obstacle is the need to establish national tax and customs administrations, which are essential to successfully implement a VAT.

[9] This might initially be best achieved by ensuring closer coordination between the Tax Department and the Vientiane Municipality Office, as most of the large taxpayers are administered by these two offices.

- Further progress is needed under the Public Expenditure Management Strengthening Program. The main emphasis in 2005/06 will be on: (i) strengthening control over provincial treasuries, notably with regard to ensuring that all national revenues are transferred to the center in a timely manner; (ii) strengthening budget planning and execution, by updating the budget's nomenclature and developing supporting accounting systems; and (iii) improving cash management, through the development of a quarterly cash management plan.

- The forthcoming Public Expenditure Review with the World Bank will be an important vehicle for clarifying the government's medium-term fiscal strategy and building consensus and support within government for expenditure reforms. Work on the review has started, and is expected to be completed by mid-2006.

12. **The bank reform process needs to be reinvigorated.** Given the difficulties in restructuring the two state banks, greater priority is being given to finding joint venture partners for the banks. The AsDB is also helping the authorities strengthen the governance agreements for the state banks.[10] Reforms proposed include streamlining the banks' management structures, strengthening their performance indicators, and re-establishing a prudential lending framework. The first tranche of bank recapitalization bonds also needs to be issued to start addressing the capital deficiency of the state banks. This should be accompanied by more active involvement of the Ministry of Finance, as shareholder, in the bank restructuring program, to avoid a repeat of the failed recapitalization experience in the 1990s.

13. **Oversight of the banking system needs to be further developed**. In addition to strengthening the regulatory framework and the BoL's supervisory capacity, the scope of bank supervision needs to be broadened beyond the two major state banks, to assess the soundness of the private banks. The first step would be to develop standard financial soundness indicators for the banking system to identify potential problem areas.

14. **The 2003 audit for the BoL, which is now long overdue, should be finalized**.[11] While there is no consensus on contracting an international firm to audit the BoL, the authorities are taking steps to develop the capacity of the State Audit Organization (SAO) to audit a central bank. An IMF technical assistance mission visited Vientiane in May to advise the SAO on how to conduct a central bank audit to international audit standards (ISA). A follow-up visit is expected in September after the field work for the BoL audit is completed.

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[10] The current agreements, which were adopted in 2003, were designed to strengthen the banks' operating framework. The banks' management, the Ministry of Finance, and the Bank of Lao P.D.R. are signatories to the agreements.

[11] Staff understand that the authorities plan to combine the 2003 and 2004 audits this year, to shorten the delay in finalizing the BOL's audited accounts.

Fund Relations

15. **The staff expect to remain engaged in a close policy dialogue with the authorities**,[12] working in collaboration with the World Bank and AsDB. The next mission will be in the fall for the 2005 Article IV Consultation, for discussion by the Board in early 2006. Staff have also offered to continue—and expand, if requested—technical assistance in the Fund's core areas of expertise, such as revenue administration, expenditure management, and bank supervision.

[12] The recent PRGF arrangement expired on April 24, 2005.

Table 1: Lao P.D.R.: Selected Economic and Financial Indicators, 2001-2005

Nominal GDP (2004): $2,451 million
Population (2003): 5.66 million

	2001	2002	2003 Est.	2004 Proj	2005 Latest 1/		2005 Proj
Real GDP growth (percentage change)	5.8	5.8	5.8	6.4	...		7.3
Inflation (annual percent change)							
Period average	7.8	10.6	15.5	10.5	7.6		5.9
End of period	7.5	15.2	12.6	8.7	5.4		5.4
Government budget (in percent of GDP) 2/ 3/							
Revenue	13.2	13.1	11.0	11.3	5.6	4/	11.2
Grants	3.1	2.0	2.1	1.1	1.0	4/	1.6
Expenditure	20.7	18.4	18.9	15.8	8.1	4/	16.8
Overall balance (including grants)	-4.4	-3.3	-5.8	-3.4	-1.4	4/	-4.0
Government debt	69.9	73.5	82.7	82.8	75.7	4/	75.6
of which: bank restructuring bonds (excluding debt clearance bonds)	0.0	0.0	0.0	0.0	0.0	4/	0.7
Money and Credit (annual percent change) 2/ 5/							
Reserve money	-19.3	19.4	23.7	30.9	14.3	6/	16.5
Broad money	7.8	12.9	24.1	21.0	10.6	6/	15.0
Bank credit to the economy	27.6	-5.2	5.4	10.1	13.6	6/	10.7
Interest rates (end of period) 2/							
On three-month deposits	16	17	10-15	9-11	6-8		...
On short term loans	12-18	12-20	22-25	16	13		...
Balance of payments (in millions of U.S. dollars)							
Exports	362	370	462	521	...		652
Imports	650	633	723	972	...		1050
Current account balance (including official transfers)	-146	-131	-159	-322	...		-465
(in percent of GDP)	-8.3	-7.2	-7.6	-13.2	...		-16.5
Gross official reserves (in millions of U.S. dollars)	134	196	216	227	221	7/	245
(in months of prospective goods and services imports) 8/	2.4	3.2	3.2	3.1	2.7	7/	3.0
(in percent of short-term debt)	352	419	336	322	291	7/	324
External public debt 9/							
(in millions of U.S. dollar)	1,213	1,330	1,915	2,014	...		2,128
Net present value (in percent of exports)	...	220	200	185	...		161
External public debt service							
(in millions of U.S. dollars)	36	36	40	69	...		77
(in percent of exports)	6.8	6.7	6.6	9.7	...		8.9
(in percent of revenue, excluding grants)	18.2	16.8	13.5	14.9	...		17.4
Exchange rate							
Commercial bank rate (kip per dollar; end of period)	9,490	10,680	10,467	10,377	10,977	10/	...
Nominal effective exchange rate 11/	95.7	83.3	73.1	71.2	71.4	6/	
Real effective exchange rate 11/	102.1	97.3	97.6	103.2	104.2	6/	...
Memorandum item:							
Nominal GDP (in billions of Kip)	15,705	18,390	22,189	26,018	...		29,836

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

1/ Latest data are for June 2005 unless otherwise indicated.
2/ Fiscal year basis (October to September).
3/ Numbers for 2004 are estimates and for 2005 are staff proposal.
4/ Fiscal data for Oct 2004-April 2005.
5/ Money and credit data are evaluated at constant exchange rates.
6/ As of April, 2005.
7/ As of June 24, 2005.
8/ Excludes imports associated with NT2 and the large Oxiana and Pan Australian mining projects.
9/ Russian debt for 2003-2005 is based on a preliminary agreement between the Lao P.D.R. and Russian governments. Prior to 2003 the Russian debt is excluded.
10/ As of July 19, 2005.
11/ Base Year 2000=100.