

**Lao P.D.R.: Assessment Letter for the Asian Development Bank and World Bank
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Contact person: Mr. Ben Bingham (bbingham@imf.org, (202) 623-4258)

1. This note provides an update of the assessment of Lao P.D.R.'s macroeconomic conditions and outlook presented at the time of the 2005 Article IV Consultation.¹

Economic Conditions and Outlook

2. **The economy continued to perform well in the first half of 2006** (Tables 1 and 2). Economic growth is robust—staff project real GDP growth of 7-7½ percent in 2006—and while headline inflation remains high (8 percent), this reflects mainly a sharp increase in food and fuel prices.² Core inflation has been more subdued (5-6 percent). The external position has also strengthened: a surge in mining exports, combined with buoyant tourism receipts and substantial foreign direct investment inflows, helped raise external reserves to just under \$260 million (3.1 months of imports) at end-March 2006.

3. **Provided that sound macroeconomic policies are sustained, the short-term economic outlook remains favorable.** GDP growth is projected to stay in the range of 6-7 percent, driven largely by a continued expansion in the mining and hydropower sectors. Unless there are further shocks to food and fuel prices, inflation should ease in the second half of the year. Buoyant export growth and foreign direct investment inflows should enable a further build-up of external reserves in 2006.

4. **The staff's medium-term outlook is broadly unchanged from that reported at the time of the 2005 Article IV Consultation.** With a number of major projects in the mining and hydropower sectors in the pipeline, Lao P.D.R. has the potential to sustain robust economic growth and reduce poverty, provided that progress is made in structural reforms and public borrowing for these projects does not jeopardize debt sustainability.³ Steps to improve revenue mobilization and public expenditure management will be particularly important, as will reforms to strengthen the banking system. Further efforts will also be needed to advance trade reforms and enhance the investment climate. Given Lao P.D.R.'s high public debt burden, prudent debt management will continue to be important.

¹ The 2005 Article IV Consultation was concluded on March 8, 2006.

² The government has fully passed on the recent increases in global oil prices to consumers.

³ Staff have revised the external current account deficit upward in 2007–08 (to 25 percent of GDP) to reflect additional capital imports of new hydropower projects that will be coming on stream. These imports will be (more-than) matched by increased foreign direct investment. Some public borrowing is also anticipated to finance the government's equity share in these projects (20 percent).

Recent Policy Developments

5. **The performance of the budget in the first half of 2005/06⁴ was encouraging** (Table 3). Revenue collections through June performed well, boosted by higher mining royalties, an increase in the excise on diesel, and adjustments in turnover and excise tax rates introduced in October 2005.⁵ Robust growth in the domestic tax base, partly reflecting higher inflation, also contributed. Total expenditure was in line with expectations, and staff project the deficit to remain in the region of 3-3½ percent of GDP. A surge in the wage bill in the second quarter raised concern, given the need to increase funding for non-wage spending in priority sectors. However, the authorities have indicated that this likely reflected clearance of wage arrears, and that they intend to keep a tight control over wage expenses.

6. **The main parameters of the 2006/07 budget approved by the National Assembly are broadly in line with a framework discussed with staff in May.**⁶ The principal challenge was to ensure a sound budget framework, based on achievable revenue targets and with sustainable spending plans, especially for the wage bill. The budget framework appears to have met these two criteria. The revenue target (12.1 percent of GDP) is achievable, even somewhat conservative, given the outlook for mining royalties and taxes projected for 2006/07.⁷ On the spending side, the budget limits the wage bill to 4 percent of GDP, which would stabilize it at around a third of revenues, and provide room for further increases in the non-wage budget allocations for priority sectors.

7. **Staff have flagged a number of risks to the budget outlook to the authorities.** On the revenue side, the main risk is that mining royalties, collected by the provinces, may not be fully remitted to the center. There is also a risk that the surge in mining royalties and taxes projected in the next few years may lead to a diminution of effort to collect non-resource revenues. Staff also have reservations about the estimate for externally financed capital outlays—and by extension the overall budget deficit (4.2 percent of GDP)—as these outlays are not consistent with projected donor financing or the need to gradually reduce the debt burden. A substantial increase in new externally financed projects may also stretch the limited domestic capacity to evaluate investment projects and ensure that public funds are invested wisely.

⁴ The fiscal year runs from October to September.

⁵ Key changes included moving from three to two rates on the turnover tax, and reforming excises to replace specific with ad valorem rates and basing these on wholesale prices rather than production cost estimates. The revenue impact of the latter, in particular, appears to have been greater than staff had earlier estimated.

⁶ The National Assembly approved the 2006/07 budget framework in June, four months earlier than usual, to give the Ministry of Finance more time to prepare the detailed budget estimates before the start of the fiscal year in October. This assessment is based on provisional information made available to staff in early July.

⁷ Staff is projecting revenues to rise to 12.4 percent of GDP (from 11.6 percent of GDP in 2005/06), driven largely by a substantial increase in mining royalties and taxes (0.8 percent of GDP).

8. **Staff have also encouraged the authorities to make further progress in a number of fiscal areas in 2006/07.** On the revenue side, the main priority is to advance the process of recentralizing the tax and customs administration. The authorities have reported some progress on this front, in the context of their discussions with the National Assembly on the reform of the Budget Law. The reforms proposed by the Ministry of Finance, which include giving the Ministry of Finance sole authority over budget execution, and clarifying the revenue assignments between the center and provinces, would be an important step forward in this regard. Staff have also welcomed the authorities' intention to move ahead with implementing the new customs law, which has fallen behind schedule, and their decision to re-establish a mandatory Tax Identification Number, with assistance from Sweden. Staff have encouraged the authorities to start planning the next round of tax reforms. Priorities include bringing the turnover tax closer into line with a VAT, rationalizing the structure of excises, and scaling back tax exemptions and investment incentives issued at the local level.

9. **The authorities are also encouraged to improve the allocation of spending in the domestic budget.** In recent years, the budget allocation for priority sectors⁸ in the government's national development plan has shrunk, as the share of spending on other sectors, including the Ministry of Defense, has increased. Staff have emphasized that addressing this imbalance, when the expenditure ceilings for line ministries and provinces are established in the coming months, will be important to improve budget outcomes and increase the confidence of donors in the government's budget framework. It will also be important to press ahead with the Public Expenditure Management Strengthening Program being supported by the World Bank.

10. **Staff's assessment of the medium-term debt outlook is also unchanged from the 2005 Article IV Consultation.** Public debt ratios—currently at high levels—are projected to decline over time, provided strong economic growth and improved revenue performance are sustained. Nevertheless, given the tight borrowing space, the authorities' public financing policy should continue to focus on mobilizing grants and highly concessional loans to meet their development needs, with borrowing on non-concessional terms limited to projects with firm financial viability. In this context, staff have urged the authorities to assess carefully the implications of the proposal to finance an equity stake in the Nam Ngum 2 hydropower project through the issuance of bonds in Thailand. More generally, the authorities need to build-up their domestic capacity to evaluate the viability of major projects in the mining and hydropower sectors and strengthen the policy framework governing these sectors⁹. This will be particularly important given the ambitious pipeline of investment in these sectors.

⁸ Education, health, agriculture, and infrastructure.

⁹ The main priority is to develop a robust framework for negotiating concession agreements and policy guidelines concerning the government's equity participation in major projects.

11. **The authorities have indicated that monetary policy in 2006/07 will continue to be geared towards reducing inflation.** Tight control over the Bank of Lao P.D.R.'s (BoL) net domestic assets will remain the main anchor of monetary policy. The main challenge confronting the BoL will be to rein in the rapid credit expansion at the state-owned commercial banks (SOCBs), which is continuing to pose a risk to the financial stability of BCEL and LDB, the two largest SOCBs. In this context, the decision to reduce bank reserve requirements in June¹⁰—partly to accommodate the expansion of credit at the SOCBs—is risky, especially as the BoL has yet to put in place a well defined prudential framework for bank liquidity requirements.

12. **The authorities have reported that there have been some positive developments in the banking sector that mitigate some of the risks raised by staff.** A rebound in foreign currency deposits has helped ease some of the liquidity pressures at the SOCBs in the first quarter of 2006, and a strategic investor has been found for the Thakhek cement project, which would limit the need for further credit from the SOCBs for this project. Furthermore, both banks are reporting a broad improvement in their financial position: the level of non-performing loans on new lending had been kept at low levels, and both banks have reported operating profits during 2005 and the first quarter of 2006.

13. **Nevertheless, it is clear that the SOCBs remain in a highly vulnerable position.** In addition to being highly insolvent, both banks are exposed to significant risks from an inordinate degree of loan concentration and foreign currency exposure. The pressure to extend directed credits also continues to pose a significant risk to financial stability of the banks. Given the difficulty of restructuring the two banks in their current format, staff have continued to encourage the authorities to find joint venture partners for these banks. In the interim, the priority should be on accelerating reforms under the state bank restructuring program being supported by the AsDB.

14. **The authorities basic approach to exchange rate management continues to be appropriate.** The stability of the kip against the baht has served Lao P.D.R. well. While the appreciation of the kip against the dollar has had an adverse impact on some sectors (e.g., coffee), its overall effect has been more limited, as the currencies of Lao P.D.R.'s major trading partners (the baht, euro, and yen) have also appreciated against the dollar. The export sector has also benefited from an improvement in its terms of trade from the recent rise in commodity prices. However, staff have encouraged the authorities to monitor closely the impact of exchange rate movements on the budget and state-owned commercial banks. The latter is particularly important as these banks have large open foreign exchange positions.

¹⁰ The reserve requirement was reduced from 8 to 5 percent for kip deposits and from 15 to 10 percent for foreign currency deposits.

Status of Fund Relations

15. **Staff expect to remain engaged in a close policy dialogue with the authorities, working in close collaboration with the World Bank and AsDB.** To this end, staff plan to undertake two missions to Lao P.D.R. each year, one of which will coincide with the annual Article IV Consultation. Staff have agreed to provide assessment letters to the World Bank and the AsDB after the mid-year missions.

Table 1. Lao P.D.R.: Selected Economic and Financial Indicators, 2002-07

Nominal GDP (2004): \$2,451 million
 Population (2004 proj.): 5.79 million
 GNI per capita (Atlas method, 2004): \$390

	2002	2003	2004	2005	2006 Proj.	2007
GDP and prices (percentage change)						
Real GDP growth	5.9	6.1	6.4	7.0	7.3	6.6
CPI (annual average)	10.6	15.5	10.5	7.2	7.7	5.0
CPI (end year)	15.2	12.6	8.7	8.8	7.0	5.0
Public finances (percent of GDP) 1/						
Revenue	13.1	10.9	11.0	11.4	11.6	12.4
<i>Of which: Resource revenues 2/</i>	2.4	1.3	1.1	1.3	1.5	2.3
Grants	2.0	2.1	1.1	1.4	1.4	1.3
Expenditure	18.4	18.6	15.5	16.0	16.1	16.4
Overall balance (including grants)	-3.3	-5.7	-3.4	-3.2	-3.2	-2.7
Money and Credit (annual percent change) 1/ 3/						
Reserve money	19.4	23.7	30.9	7.2 4/	19.6	16.3
Broad money	12.9	24.1	21.0	8.1 4/	16.8	18.1
Bank credit to the economy	-5.2	5.4	10.1	27.9	15.0	15.0
Interest rates (end of period) 1/						
On three-month deposits	17	10-15	9-11	5-10	...	...
On short term loans	12-20	22-25	16	16-24	...	...
Balance of payments						
Exports (percent change)	2.3	24.1	11.0	31.4	49.6	2.3
Imports (percent change)	-2.6	26.6	40.9	23.8	13.8	36.8
Terms of trade (percent change)	10.6	6.8	0.8	4.3	29.0	-6.4
Trade Balance (percent of GDP)	-14.5	-11.4	-19.1	-19.3	-11.4	-23.4
Current account balance (percent of GDP)	-7.2	-8.2	-14.3	-19.9	-14.6	-24.9
Gross official reserves (in millions of U.S. dollars)	196	216	227	238	270	290
(In months of prospective goods and services imports) 5/	3.0	3.7	3.4	3.1	3.3	3.3
(In percent of short-term debt)	419	307	278	162	181	222
External public debt 6/						
(In millions of U.S. dollars)	1,717	1,915	2,086	2,225	2,416	2,569
(In percent of GDP)	94.4	89.6	83.4	77.4	70.0	68.4
Net present value (in percent of exports)	...	205	199	166	128	134
External public debt service						
(In millions of U.S. dollars)	36	40	52	67	73	79
(In percent of exports)	6.7	6.7	7.5	7.6	5.8	6.1
(In percent of revenue, excluding grants)	15.3	17.3	18.7	20.4	18.3	16.8
Exchange rate						
Commercial bank rate (kip per dollar; end of period)	10,680	10,467	10,377	10,800	...	...
Nominal effective exchange rate (2000=100)	83.3	73.1	71.2	71.0	...	...
Real effective exchange rate (2000=100)	97.3	97.6	103.2	106.7	...	...
Memorandum item:						
Nominal GDP (calendar year; in billions of kip)	18,401	22,598	26,540	30,678	35,554	39,784

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

1/ Fiscal year basis (October to September).

2/ Royalties and taxes from timber, mining and hydro-power projects.

3/ Money and credit data are evaluated at current exchange rates.

4/ The slowdown in broad money and reserve money in 2005 largely reflects a decline in foreign currency deposits and associated bank reserves, following withdrawals by NTPC and the Oxiana mining project.

5/ Excludes imports associated with NT2 and the large Oxiana and Pan Australian mining projects.

6/ Includes Russian debt, which is based on a preliminary agreement between the Lao P.D.R. and Russian governments.

Table 2 - Lao P.D.R.: Balance of Payments, 2003–10

	2003	2004	2005	2006	2007	2008	2009	2010
			Est.			Projections		
(In millions of U.S. dollars, unless specified otherwise)								
Current Account	-175	-358	-573	-504	-934	-968	-819	-543
Excluding official transfers	-237	-417	-630	-582	-1014	-1046	-902	-632
Merchandise trade balance	-244	-478	-553	-394	-879	-866	-826	-528
Exports, f.o.b., of which:	450	500	656	982	1004	1199	1281	1556
<i>NT2 and large mining projects 1/</i>	60	58	213	526	555	738	802	1053
<i>new hydropower projects 2/</i>		0	0	0	0	0	5	25
Imports, c.i.f., of which:	694	977	1210	1376	1883	2065	2107	2084
<i>NT2 and large mining projects 1/</i>	45	232	342	345	616	613	494	431
<i>new hydropower projects 2/</i>	0	0	17	108	276	385	469	445
Services (net)	95	132	167	197	212	229	247	267
of which tourism	84	119	156	186	201	217	235	255
Income (net)	-113	-98	-272	-414	-380	-445	-362	-412
Interest payments, of which:	-38	-54	-106	-102	-117	-120	-97	-117
public	-15	-27	-31	-33	-34	-36	-38	-39
<i>NT2 and large mining projects 1/</i>	0	-6	-56	-53	-68	-72	-49	-71
<i>new hydropower projects 2/</i>	0	0	0	0	0	-5	-6	-7
Dividends and profit repatriation, of which:	-78	-56	-182	-341	-299	-365	-311	-345
<i>NT2 and large mining projects 1/</i>	-34	-7	-95	-251	-224	-283	-222	-248
<i>new hydropower projects 2/</i>	0	0	0	0	0	0	0	-7
Other	3	12	16	29	35	40	45	50
Transfers (net)	86	85	85	108	112	113	122	130
Private	24	26	28	30	33	35	38	41
Official	62	60	57	77	80	78	84	89
Capital Account	197	377	590	538	972	1002	855	582
Public sector	118	118	115	187	152	120	104	97
Disbursements	146	147	156	233	202	187	177	173
Amortization	-28	-29	-41	-46	-50	-67	-73	-76
Banking sector (net)	-21	-39	15	-14	-21	-45	-50	-50
Private sector	100	297	460	365	841	927	801	534
Foreign direct investment (net), of which:	42	234	349	303	785	855	742	460
<i>NT2 and large mining projects 1/</i>	30	198	291	150	453	403	201	-65
<i>new hydropower projects 2/</i>	0	0	17	111	284	402	489	463
Other private flows and errors and omissions	58	63	111	62	56	73	59	75
Overall Balance	22	19	17	34	38	34	36	39
Financing	-22	-19	-17	-34	-38	-34	-36	-39
Central bank net foreign assets	-22	-19	-17	-34	-38	-34	-36	-39
Assets (increase -)	-18	-12	-11	-32	-35	-30	-30	-30
Liabilities (reduction -)	-4	-7	-6	-1	-3	-4	-6	-9
Memorandum Items:								
Current account (percent of GDP)	-8	-14	-20	-15	-25	-24	-18	-11
(excluding official transfers)	-11	-17	-22	-17	-27	-26	-20	-13
Official gross reserves (in millions of USD)	216	227	238	270	290	320	350	380
(in months of imports, excl. large projects 1/)	3.7	3.4	3.1	3.3	3.3	3.4	3.4	3.5
Nominal GDP at market prices (in millions of USD)	2,138	2,501	2,875	3,454	3,758	4,103	4,470	4,921

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

1/ Nam Theun 2 hydroelectric dam and Lane Xang (Oxiana) and Phu Bia (Pan Australian) mining projects.

2/ Includes Xeset 2, Nam Ngum 2, Theun Hinboun Expansion, Xe Kaman 3, Nam Ngum 3, Nam Ngiep 1 power stations

Table 3. Lao P.D.R.: General Government Operations 2003/04-2006/07

	2003/04	2005/06			2006/07	
		Budget	Oct.-Mar. est.	Staff	Budget	Staff Proposal
(In billions of kip)						
Revenue and grants	3,103	5,285	2,486	4,432	5,370	5,296
Revenue	2,821	3,925	2,172	3,967	4,689	4,811
Tax	2,328	3,329	1,955	3,385	4,086	4,172
<i>Of which: Resource revenues 1/</i>	289	...	...	516	...	881
Nontax	493	595	217	582	602	638
Grants	283	1,360	314	466	681	485
Expenditure	3,967	6,695	2,683	5,528	7,005	6,346
Current	1,890	2,949	1,362	3,092	3,377	3,670
Wages, salaries and benefits	833	1,310	629	1,309	1,540	1,506
Compensations and allowances	243	430	192	431	487	481
Subsidies and transfers	124	280	127	280	350	310
Interest payments	235	353	175	305	305	405
Other recurrent	456	576	239	767	695	968
Capital and onlending	1,853	3,491	1,203	2,181	3,192	2,347
Domestically financed 2/	799	424	148	597	517	610
Externally financed	1,169	3,225	1,107	1,742	2,836	1,859
Onlending (net)	-115	-158	-53	-158	-162	-123
Debt repayment/unallocated budget	224	255	118	255	437	330
Overall balance	-864	-1,410	-196	-1,096	-1,636	-1,051
Financing	864	1,410	196	1,096	1,636	1,051
Domestic financing (net)	-59	-71	-162	0	-44	-68
Bank financing 3/	-66	-88	-170	0	-44	-68
Nonbank financing	6	17	8	0	0	0
Foreign financing (net) 4/	923	1,482	774	1,095	1,680	1,119
Disbursements	1,151	1,910	926	1,562	2,239	1,641
Amortization	-228	-428	-153	-466	-559	-522
Discrepancy/Financing gap	0	0	0	0	0	0
(In percent of GDP)						
Revenue and grants	12.1	16.0	7.2	12.9	13.9	13.7
Revenue	11.0	11.9	6.3	11.6	12.1	12.4
Tax	9.1	10.1	5.7	9.9	10.6	10.8
<i>Of which: Resource revenues 1/</i>	1.1	...	...	1.5	...	2.3
Nontax	1.9	1.8	0.6	1.7	1.6	1.6
Grants	1.1	4.1	0.9	1.4	1.8	1.3
Expenditure	15.5	20.2	7.8	16.1	18.1	16.4
Current	7.4	8.9	4.0	9.0	8.7	9.5
Wages, salaries and benefits	3.3	4.0	1.8	3.8	4.0	3.9
Compensations and allowances	1.0	1.3	0.6	1.3	1.3	1.2
Subsidies and transfers	0.5	0.8	0.4	0.8	0.9	0.8
Interest payments	0.9	1.1	0.5	0.9	0.8	1.0
Other recurrent	1.8	1.7	0.7	2.2	1.8	2.5
Capital and onlending	7.3	10.5	3.5	6.4	8.2	6.1
Domestically financed 2/	3.1	1.3	0.4	1.7	1.3	1.6
Externally financed	4.6	9.7	3.2	5.1	7.3	4.8
Onlending (net)	-0.5	-0.5	-0.2	-0.5	-0.4	-0.3
Debt repayment/Contingency	0.9	0.8	0.3	0.7	1.1	0.9
Overall balance	-3.4	-4.3	-0.6	-3.2	-4.2	-2.7
Financing	3.4	4.3	0.6	3.2	4.2	2.7
Domestic financing (net)	-0.2	-0.2	-0.5	0.0	-0.1	-0.2
Foreign financing (net) 4/	3.6	4.5	2.3	3.2	4.3	2.9
Disbursements	4.5	5.8	2.7	4.5	5.8	4.2
Amortization	-0.9	-1.3	-0.4	-1.4	-1.4	-1.3
Discrepancy/Financing gap	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:						
GDP (in billions of kip)	25,555	33,109	34,335	34,335	38,726	38,726
Exchange rate (kip per US dollar)	10,594	10,942	...	10,396	...	...
Domestic expenditure (in percent of GDP)	10.9	10.5	...	11.0	10.8	11.6
Wages, salaries, and benefits (in percent of revenue)	29.5	33.4	...	33.0	32.8	31.3
Total aid (in millions of US dollars)	135.1	298.9	...	195.0	278.1	198.8
Project aid	110.3	294.7	...	167.5	260.8	173.9
Program aid	24.9	4.1	...	27.5	17.3	24.9

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

1/ Royalties and taxes from timber, mining, and hydro-power projects.

2/ In 2003/04 includes discrepancy.

3/ Excludes bank restructuring bonds.

4/ Foreign financing does not include loans for government equity contribution to the NT2 project.