

Lao PDR

Lao PDR continues to enjoy rapid economic growth and impressive poverty reduction. Growth increased to 7.0 percent in 2005, up from 6.4 percent in 2004, and is estimated at about 7.5 percent in 2006. It is expected to remain at above 7 percent in the next few years - 7.1 percent for 2007 and 9.0 percent for 2008. Growth is being driven by FDI inflows in mining and hydro-power, by agriculture and processing industries as well as growing mineral exports. Non-hydro/mining sectors (agriculture, manufacturing and services/tourism) are expected to sustain growth and pick-up pace, due to rising FDI in those sectors. The share of agriculture in GDP has been falling and is expected to drop further from 45 percent in 2005 to about 38 percent by 2008 while the contribution of industry should jump from 30 percent to 37 percent, with most of the growth coming from the power and mining sectors. Consumer price inflation continued to decline in 2006, falling to 6.8 percent on average (4.7 percent in December 2006) compared to 7.2 percent in 2005. It is expected to drop to around 4 percent in 2007 and 2008.

Macroeconomic conditions remain relatively stable, reflecting improved monetary and fiscal discipline, with inflation in single digits for the last a few years, and public expenditures under control. Budget revenues rose from 11.4 to 12.1 percent of GDP (FY2005/06), well above the original target of 11.4 percent. The budget deficit shrunk sharply, from 3.3 percent of GDP in FY2004/05 to 1.2 percent in FY2005/06 – especially due to capital expenditures below allocations. In FY2006/07, revenue is expected to increase to about 12.4 percent of GDP with the budget deficit at about 2 percent of GDP. The challenge for Lao PDR is to sustain this good revenue and fiscal performance in the future. The government has also continued to maintain a tight monetary policy stance and exchange rate stability in recent years. Reserves increased above the 3 months of imports mark in 2006 and should stay at that level in the coming years because of expected increases in mining exports, tourism receipts, and FDI inflows. However, the imports associated with large projects continue to push up the external current account deficit as a percent of GDP.

Lao PDR's external public debt burden remains high, but the debt service burden should be manageable with a prudent borrowing strategy. According to the latest joint Bank-Fund staff Debt Sustainability Analysis (DSA), at end-2004, Lao PDR's stock of public and publicly guaranteed external debt amounted to USD 2.1 billion in nominal terms and USD 1.36 billion in net present value (NPV) terms. This was equivalent to about 83 percent of GDP, or 55 percent of GDP in NPV terms (with indicative threshold of 30). The NPV of external debt comprised 199 percent of exports (with indicative threshold of 100) and 495 percent of fiscal revenues (with indicative threshold of 200). All three debt indicators exceed the indicative sustainability thresholds for countries with comparable CPIA ratings, placing Lao PDR in IDA's "high risk of debt distress" category. A prudent debt strategy would consist of borrowing on only concessional terms, supported by continuation of structural reforms, including SOE, banking and public financial management reform, together with stronger revenue collection and better prioritization of public expenditures.

The Government disseminated the final draft of the 6th National Socio-Economic Development Plan. The Plan presents a candid assessment of progress on structural reform in the last five years, and lays out the strategy for the next five years based on lessons learnt. After the Round Table Meeting between the government and its development partners on November 28-29, it was decided that the Plan will be submitted as a Poverty Reduction Strategy (PRS). Progress has been good on the Public Financial Management reform agenda, with the Budget law drafted ahead of schedule. The Public Financial Management Strengthening Program (PEMSP) is gaining momentum. Efforts to improve public financial management are occurring on time before the point when revenues from the Nam Theun 2 project start coming on stream, in 2009/10. The Government is also trying to strengthen oversight of the State Owned Enterprises (SOEs). Good progress has also been achieved on private sector and trade reform. The new Enterprise Law has been approved but awaits the issuing of implementing decrees. Lao PDR is working on WTO accession. The legislative action plan has been prepared and initial offers on goods and services are being discussed in Geneva. Progress continues on commitments to reduce tariffs under AFTA and to introduce single window under ASEAN. At the Round Table Meeting, the Government presented a comprehensive strategy for private sector development and trade focusing on improving the investment climate and including reduction in cumbersome regulations and procedures at and behind the border.

Reform of state-owned banks has been slow, but there are new initiatives that will contribute to leveling the playing field in the banking sector. The SOE sector is borrowing less from banks and receiving lower subsidies from the government, while large SOEs are undergoing restructuring and adjustment in output prices. But the restructuring of state-owned commercial banks is not going well. The urgent priorities are to implement the modified Governance Agreements and make better use of the International Banking Advisors, strengthen the oversight and supervision of banks and reduce NPLs. There is also need to obtain private strategic partners. The government has already received several offers from international investors. There is also a need to 'level the playing field' for all state-owned and private banks, but progress on this account has been slow. The government has prepared the new Financial Institutions Law which seeks to level the playing field for all banks.

Some risks remain at the macro level: mainly fiscal pressures and upcoming boom in large projects. . It will be a continuous challenge to sustain and improve revenue performance. New exemptions introduced on imports of petroleum products will tend to erode the revenue base. There is a need to widen the non-resource revenue base. There are also pressures to raise wages, albeit from a relatively low base. Another potential risk is the upcoming boom in mining and hydro-power investment which may bring some standard risks such as Dutch disease. In addition, the GOL is taking equity stakes in all new hydropower projects, in addition to royalties and taxation. Given the limited public resources available and the speed of expansion in this sector, such policy may eventually undermine Lao PDR's debt sustainability as well as financial sustainability of the state electricity company (EDL, Electricité du Laos) through which these stakes are taken. The accumulation of arrears to utility companies should be kept under control. The government should consider using increased revenues to cover these obligations.