# AMRO Annual Consultation Report

## Lao PDR - 2019

The ASEAN+3 Macroeconomic Research Office (AMRO)

July 2019

## Acknowledgements

1. This Annual Consultation Report on Lao PDR has been prepared in accordance with the functions of AMRO to monitor, assess and report to its member macroeconomic status and financial soundness and to identify the relevant risks and vulnerabilities, and assist them in the timely formulation of policy recommendation to mitigate such risks (Article 3(a) and (b) of AMRO Agreement).

2. This Report is drafted on the basis of the Annual Consultation Visit of AMRO to Lao PDR from 19-27 February 2019 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr. Seung Hyun (Luke) Hong (Group Head and Lead Specialist). Members include Mr. Paolo Hernando (Desk Economist for Lao PDR), Dr. Nguyen Thi Kim Cuc (Senior Economist and Back-up Economist for Lao PDR); Dr. Tanyasorn Ekapirak (Researcher and Sector Specialist for Lao PDR); Mr. Phanomphone Keovongvichith (Associate); Ms. Malichanh Chiemsisoulath (Associate); Mr. Nguyen Manh Duc (Associate); Mr. Kazuo Kobayashi (Technical Assistance Specialist). AMRO Chief Economist Dr. Hoe Ee Khor and Director Dr. Junhong Chang also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on Lao PDR for 2019 was peer-reviewed by Dr. Chaipat Poonpatpibul (Group Head and Lead Economist) and Dr. Jade Vichyanond (Economist); and was approved by Dr. Hoe Ee Khor, AMRO Chief Economist.

3. The analysis in this Report is based on information available up to 15 June 2019.

4. By making any designation of or reference to a particular territory or geographical area, or by using the term “member” or “country” in this Report, AMRO does not intend to make any judgements as to the legal or other status of any territory or area.

5. On behalf of AMRO, the Mission team wishes to thank the Lao authorities for their comments on this Report, as well as their excellent meeting arrangements and hospitality during our visit.

# Table of Contents

## Executive Summary

*The macroeconomic environment has become more challenging in 2018, as Lao PDR's economic growth slowed down, inflation rose and the external position slightly deteriorated. Maintaining macroeconomic stability amid the challenging environment remains the top priority. Towards this end, authorities need to step up their efforts to create policy buffers through fiscal consolidation and the build-up of international reserves, while continuing to enhance bank supervision and regulation.*

1. **Lao PDR's economic growth slowed in 2018 and is expected to see a mild recovery in 2019, while inflation has increased from a low base and is expected to remain stable going forward.** GDP growth slowed to 6.5 percent in 2018, and is expected to recover to 6.6 percent in 2019, supported by the robust services sector, particularly tourism, and the starting of operations of several hydropower projects. After registering a low of 0.8 percent in 2017, inflation rose to 2.0 percent in 2018, reflecting higher fuel and food prices, but is expected to remain stable going forward.

2. **Overall balance of payments (BOP) turned into a deficit as FDI inflows and bond issuances fell short of the larger current account deficit.** The current account deficit rose to 7.8 percent of GDP in 2018, mainly due to the combined effect of larger profit repatriation and interest payments, and lower remittance inflows. Despite the robust FDI inflows and external bond issuances, the BOP ended 2018 with a deficit of USD142.9 million, and international reserves declined to USD873 million.

3. **Credit growth weakened in 2018 mainly driven by the moderation in private sector lending**. Credit to all sectors except industry slowed in 2018, with credit to construction contracting. This can be traced to the tighter fiscal spending and government freeze on new projects which adversely affected private sector activities. Legacy issues such as the partial resolution of government arrears as well as the imposition of interest rate ceiling on loans, may have also dampened bank appetite to lend. In this regard, the decision to remove the interest rate ceilings on kip deposits and lending in February 2019 is a welcome development.

4. **The fiscal deficit narrowed in 2018 and is budgeted to narrow further in 2019 through a combination of revenue raising and cost cutting measures.** Preliminary figures from the government indicate that the fiscal deficit narrowed to 4.4 percent of GDP in 2018 from 5.5 percent of GDP in 2017, as expenditure was tightly controlled amid the flat growth in tax collection. The fiscal deficit is budgeted to narrow further to 4.3 percent of GDP in 2019.

5. **The economy remains vulnerable to domestic and external risks.** Setbacks in fiscal consolidation could significantly narrow the policy space needed to maintain macroeconomic stability. On the financial sector, delays in resolving the remaining arrears related to past government projects could prolong the uncertainty and weigh on credit growth as banks hold back fresh lending. On the external front, a sharp tightening in global financial conditions could put significant pressures on the exchange rate and debt servicing burden, while policy shifts and growth slowdown in major trading partners would have severe implications for the Lao economy, particularly given significant exposures to China, Thailand and Vietnam via such channels as trade, investments and tourism.

6. **Amid heightened concern about fiscal sustainability, building confidence by implementing a feasible medium-term fiscal consolidation plan remains imperative.** Although the current debt level is below the government's ceiling of 65 percent of GDP, it is relatively high compared to regional peers, and it would be prudent to reduce the debt/GDP ratio to a significantly lower level to create fiscal space. In this regard, the authorities' own consolidation plan of achieving a fiscal deficit of around 3 percent of GDP over the medium term should be sufficient to reduce debt/GDP ratio significantly over time. Stronger revenue efforts are needed to achieve this target, together with tighter expenditure control and enhanced spending efficiency. Better management of public debt and contingent liabilities also forms a crucial part of the fiscal consolidation efforts.

7. **Exchange rate management requires a careful consideration of the prevailing internal and external balances, supported by accumulation of international reserves.** Building and maintaining a healthy level of international reserves is a prerequisite for the Bank of Lao PDR (BOL) to be able to effectively contain external shocks, including excessive foreign exchange (FX) volatility. A more flexible exchange rate will require enhancing prudential regulations to help reduce the FX related risks in the private sector, and the development of market-based risk management and assessment capabilities.

8. **Continued progress is needed in enhancing bank supervision and regulation.** The passage of the New Commercial Bank Law is a welcome progress which is expected to strengthen banks' capital buffer. In addition, moving towards risk-based supervision and transitioning to Basel II standards will fortify the soundness of the financial system. With regards to the lifting of all restrictions on foreign currency lending in 2018, it is recommended that the BOL further enhance its monitoring and supervision capacity to contain risks related to currency mismatches. Parallel to this, the financial sector also needs to strengthen its ability to absorb shocks by maintaining an adequate capital level and limiting currency risks.

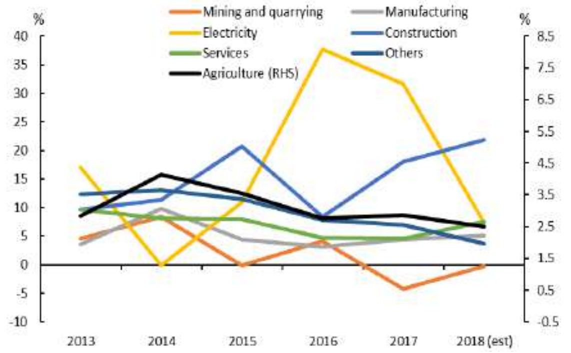
9. **Policy efforts toward structural reforms and economic diversification need to continue to enhance growth potential and economic resilience.** To improve economic resilience, the country needs to diversify its production base by developing the non-resource sectors, particularly manufacturing, tourism, and agro-based industries. As a land-locked country with limited supply of skilled labor and a small domestic market, attracting FDI to boost the non-resource sectors requires strong government commitment and policy support to improve the business environment. Maintaining much needed social and infrastructure spending based on strong prioritization is also necessary. Maximizing returns on existing and upcoming large infrastructure investments remains critical, and this could be achieved by clearly laying out plans to encourage greater private sector participation. The additional revenue that the government can generate from increased private sector participation, in turn, will help alleviate the financial burden from the projects and facilitate their sustained contribution to the development of the country.

## A. Recent Developments and Outlook

### A.1 Real Sector Developments and Outlook

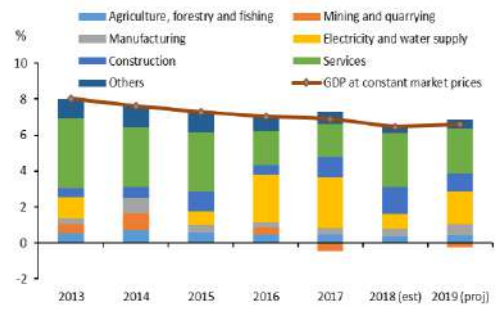
1. **GDP growth has slowed down to 6.5 percent in 2018 as mining output contracted while the agriculture and electricity sectors moderated.** Lower output from mining remains a drag on growth despite the recovery in global metal prices, as the two largest mines continue to wind down towards the expected end of production by 2020.[1] The agriculture sector, which accounts for 15 percent of the economy, was adversely affected by flooding across the country in the third quarter of 2018. Meanwhile, the electricity sector slowed down due to the high base in the previous years, and with no new generation capacity coming on stream last year. Continued tight control on public investment along with weakening credit growth also weighed down on growth. The services sector, which accounts for almost 40 percent of the economy, was the major contributor to growth, driven by strong activities in real estate, wholesale and retail trade, as well as hotels and restaurant, as tourism arrivals recovered after two consecutive years of decline. Moreover, improvements are seen in the construction sector, boosted by a strong real estate market and infrastructure developments, including the Vientiane-Vang Vieng Highway and the Lao-China Railway. Also propping up growth was the robust performance of the manufacturing sector as exports from Special Economic Zones (SEZs) have increased.

**Figure 1. Key Drivers of Growth**




Source: Lao Statistics Bureau, AMRO staff projections

**Figure 2. Contribution to GDP Growth**




Source: Lao Statistics Bureau, AMRO staff projections

2. **Growth is expected to pick up in 2019 and 2020.** Following the slowdown last year, growth is expected to increase slightly to 6.6 percent in 2019, supported by the robust services sector and improved prospects for tourism with the government's new strategy of attracting Chinese tourists. Positive base effects from the start of operations of several large hydropower projects will be spread out across the last quarter of 2019 and the rest of 2020, with installed capacity expected to increase between 2,400 – 3,100 MW.[2] Continued strong construction activity, boosted by foreign direct investments (FDI) and infrastructure projects, together with

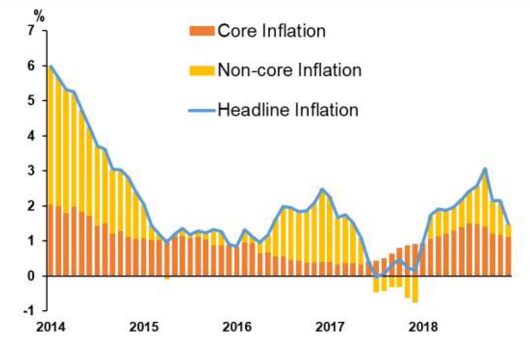
[1] There has been a moratorium on new mining operations since 2012. In 2018, this was lifted with two new mining companies granted permission to start operations. However, the output from these two new operations cannot compensate for the output of the two biggest existing mines.

[2] The biggest being Xayabury (1,287 MW) and Don Sahong (260 MW) with operations expected to commence in H2 2019. Meanwhile, the series of Nam Ou dams (1,3,4 and 7) with installed capacity of 732 MW, and Nam Pha (130 MW) are on track to begin operations by 2020. Delays have been experienced by Nam Ngiep 1 (290 MW) due to technical difficulties and Xepian-Xenamnoi (410 MW) due to the collapse of the saddle dam. If these two projects are able to start operations by 2020, total installed capacity could go up to around 10,000 MW in 2020 from 6,400 MW in 2016.

robust manufacturing with the development of SEZs, are likewise supportive of growth. Meanwhile, the gradual decline in mining, as the largest operations wind down, will continue to impact adversely on growth.

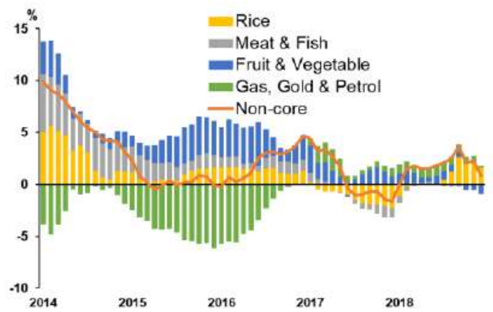
3. **Inflation has increased from a low base in 2017 and is expected to remain stable going forward.** After registering 0.8 percent in 2017, the lowest recorded in eight years, inflation rose to 2.0 percent in 2018, driven by rising fuel and food prices. Higher fuel prices, due to reduced subsidies, exerted an upward pressure on inflation, as the petrol index rose by an average of 13.6 percent during the year. Meanwhile, food prices were mainly pushed up by base effects after the decline last year, particularly for rice. Core inflation also increased to 2.2 percent in 2018 from 1.0 percent in 2017, with transportation prices pushed up by higher retail prices for petrol. Given that Lao PDR imports most of its goods from neighboring countries, the depreciation of the exchange rate against major trading partners also helped push up inflation. Going forward, inflation is expected to remain stable at around 2.1 percent in 2019, well within the five-year average of 2.8 percent, as global oil prices are expected to remain stable while domestic price pressures on food remain subdued.

**Figure 3. Headline Inflation**




Source: Lao Statistics Bureau

**Figure 4. Non-core inflation and its Components**

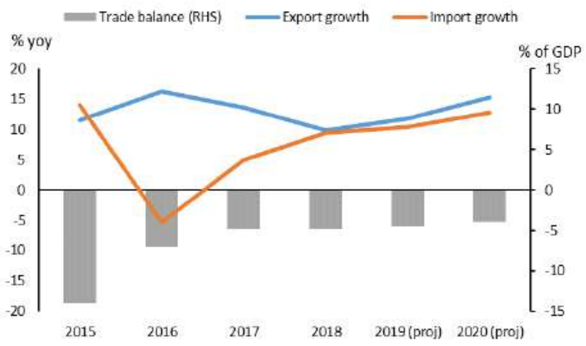



Source: Lao Statistics Bureau

## A.2 External Sector and the Balance of Payments

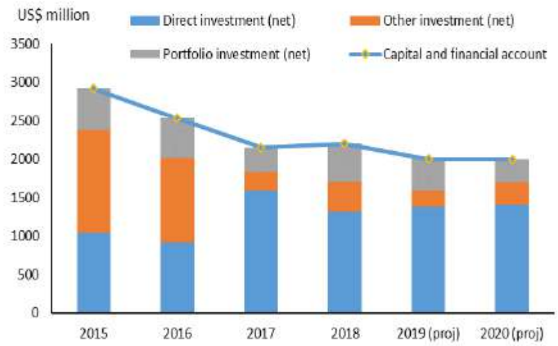
4. **The trade deficit slightly widened in 2018 as robust growth in manufacturing exports was offset by weaker exports from other sectors and strong import growth.** Exports grew by 8.7 percent in 2018, which was lower than the14.8 percent in 2017, due to contraction in agriculture exports and slower growth in exports of minerals and electricity. However, manufacturing exports, in particular from SEZs, increased sharply by almost 60 percent in 2018, accounting for 9.6 percent of total exports, up from 6.4 percent two years ago. Meanwhile, imports grew by 8.8 percent, generally offsetting the growth in exports, with the trade deficit in 2018 slightly widening by USD75 million compared to 2017. Imports were driven mainly by intermediate and capital goods related to large infrastructure projects, particularly imports of machinery and mechanical equipment as well as cement.

**Figure 5. Trade Balance**




Source: Bank of Lao PDR, AMRO staff projections

**Figure 6. Capital and Financial Account**




Source: Bank of Lao PDR, AMRO staff projections

5. **The current account deficit widened in 2018.** Amid the slightly wider trade deficit, the current account deficit rose to 7.8 percent of GDP in 2018[3] from 7.4 percent in 2017, mainly due to the combined effect of larger outflows from the primary income account due to larger profit repatriation and interest payments and lower inflows from the secondary income account as remittance inflows declined. Meanwhile, the services account saw a slight improvement with the growth in tourist arrivals.

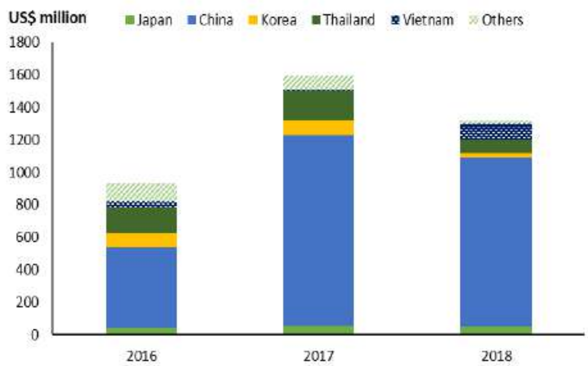
6. **Overall BOP turned to deficit as FDI inflows and bond issuances fell short of the rise in current account deficit.** FDI inflows remained strong in 2018 at USD1.3 billion with investments from China accounting for almost 80 percent of total FDI (Figure 7) and more than half of inflows into the construction sector related to large infrastructure projects (Figure 8). Despite the robust FDI inflows and external bond issuances by the government and (Electricite du Laos) EDL-Gen[4], the overall balance of payments (BOP) ended 2018 with a deficit of USD142.9 million, resulting in international reserves declining to USD873 million. The country's international reserves are estimated to cover about 1.4 months of goods and services imports (by conventional metric) or about 3.2 months of non-FDI imports according to the authorities own estimate.[5] Looking ahead, the current account deficit is expected to narrow together with a slight BOP surplus in 2019 and 2020, as electricity and manufacturing exports are expected to increase while FDI inflows are maintained. However, international reserves are projected to remain below the conventional threshold of 3-months' imports.

[3] External trade figures generated by the Lao authorities differ significantly with mirror data from major trading partners. The data gap in exports has narrowed in recent years, however, the data gap for imports remains large at almost 5 percent of GDP. In this regard, alternative estimates using mirror data from major trading partners indicate the current account deficit to be above 10 percent of GDP.

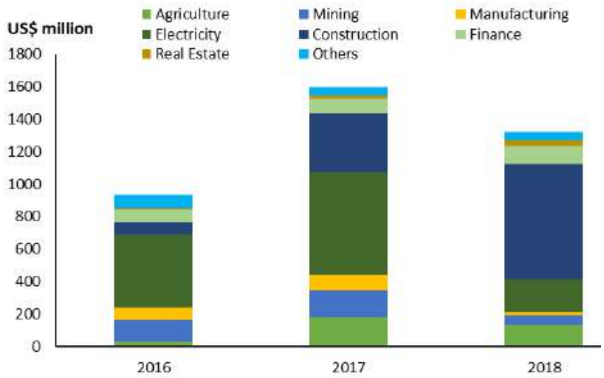
[4] Lao PDR government and EDL-Gen issued the bonds in the Thailand market worth THB6.8 billion (around USD215 million) and THB13.2 billion (around USD420 million) respectively.

[5] The authorities' estimate is based on projections of non-FDI related imports using data from the Customs Department. Meanwhile, AMRO's estimate show that, as of end-2018, gross official reserves could be equivalent to about 2.8 months of non FDI-related imports. AMRO uses trade data from the IMF's Direction of Trade Statistics (DOTS) to make projections of non-FDI imports which is defined as total imports excluding imports of investment goods.

| Figure 7. FDI by Country of Origin | Figure 8. FDI by Sector |
|---|---|



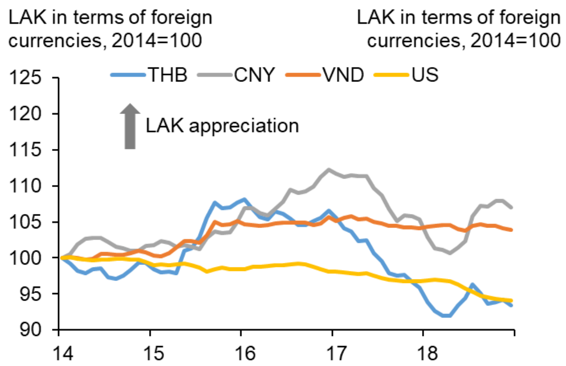

Source: Bank of Lao PDR




Source: Bank of Lao PDR

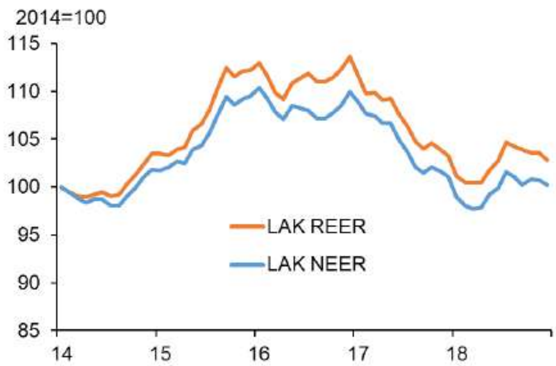
7. **The exchange rate depreciated against the US dollar in 2018 and against major trading partners helping support competitiveness.** Looking at bilateral exchange rates, the Lao kip depreciated by an average of 6.5 percent against the Thai baht and 4.0 percent against the Chinese yuan in 2018, with some appreciation during the third quarter of 2018, while the kip depreciated against the U.S. dollar by 1.8 percent (Figure 9). Amid the general depreciation of the kip against major trading partners, the LAK NEER and LAK REER likewise showed a similar trend, depreciating by an average of 4.6 and 4.2 percent in 2018, respectively, helping the tradeable sector become more competitive and supporting the diversification of the economy (Figure 10).

Figure 9. LAK Cross Rates




Source: Bloomberg

Figure 10. LAK Effective Exchange Rates



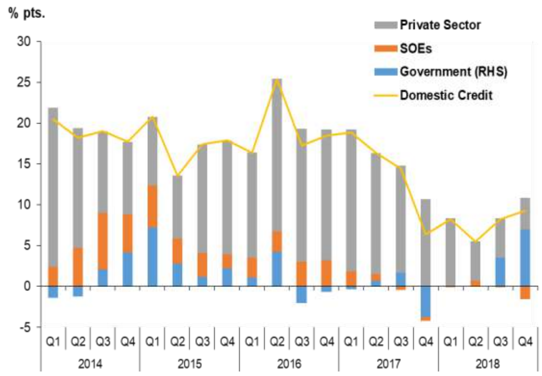

Source: Bank of Lao PDR, Bloomberg, CEIC, AMRO staff estimates

## A.3 Monetary Condition and Financial Sector

8. **Credit growth weakened in 2018 due to a combination of factors.** Domestic credit growth slowed to a low of 5.5 percent in Q2 2018 from an average growth of 14.0 percent in 2017, mainly driven by the moderation in private sector lending which accounts for over 80 percent of total credit. On the demand side, the slowdown of lending to the private sector may be traced to the tighter fiscal spending and government freeze on new projects which adversely affected the private sector. On a sectoral basis, credit to all sectors except industry slowed down, in particular, credit to construction contracted mainly due to the moratorium on

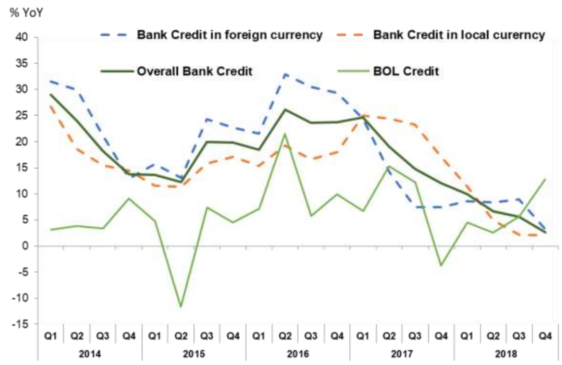
new government projects. Amid slowing credit growth to the private sector and to state-owned enterprises (SOEs), credit to government rebounded in the second half of 2018, due to an increase in credit provided by the BOL (Figure 11 and 12). Meanwhile, overall bank credit continued to trend down, as the partial resolution of past government arrears as well as the interest rate ceiling have held back bank's appetite to lend in 2018 despite the removal of restrictions on foreign currency lending in May 2018. To allow banks to better price credit risks and boost lending, particularly to SMEs, the interest rate ceilings that have been in place since 2015 were removed in February 2019.

**Figure 11. Domestic Credit Growth**




Source: Bank of Lao PDR

**Figure 12. Commercial Banks' and BOL Credit Growth**

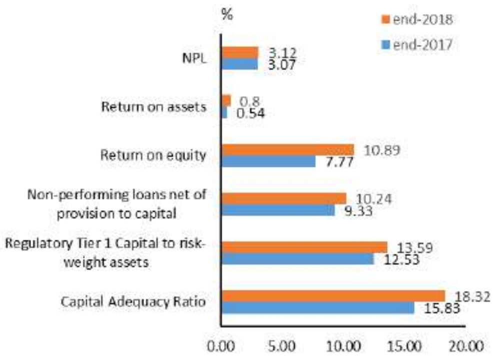



Source: Bank of Lao PDR

9. **The aggregate banking indicators remained generally sound, while the authorities have taken measures to strengthen weak state-owned banks.** Overall capital adequacy ratio for the banking system was at 18.32 percent at the end of 2018, well above the minimum requirement of 8 percent (Figure 13). The loan-to-deposit ratio (LTD) is at 93.7 percent, while the LTD for local currency lending is higher at 100 percent, but that of FX lending is at 88.5 percent (Figure 14). Bank profitability is inching up, with return on assets at 0.8 percent at the end of 2018.[6] Meanwhile, the overall non-performing loan (NPL) ratio rose slightly to 3.1 percent during the same period.[7] Notwithstanding the general soundness of the banking system, weaknesses remain as the capital of the two smaller state banks is below the regulatory requirement.[8] In addition, the process of clearing the legacy government arrears is still ongoing, with outstanding special mention loans accounting for about 2.1 percent of total bank loans as of end-2018.

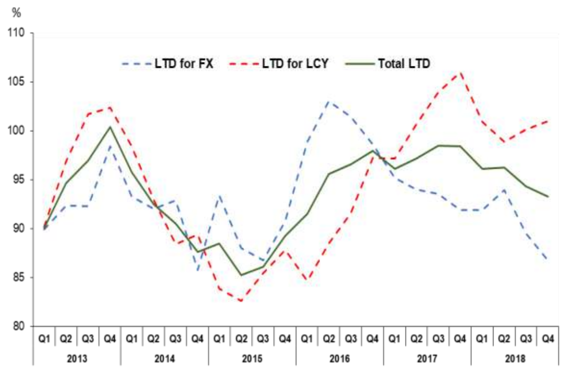
[6] This is driven by the strong performance of a large foreign bank which is acting as a conduit for large infrastructure projects in Laos profiting from fees and other non-interest income.
[7] The NPL ratio has been kept relatively low in part as a result of classifying legacy loans related to past government projects as "special mention" loans.
[8] With the largest state-owned bank recapitalized to meet the regulatory requirement, the restructuring of the other two state-owned banks are being accelerated, with new management teams focused on cleaning up the balance sheet and rolling-out improved lending practices.

**Figure 13. Financial Soundness Indicators**




Source: Bank of Lao PDR

**Figure 14. Loan-to-Deposit Ratios**




Source: Bank of Lao PDR

10. **Reforms in bank regulation and supervision are on track.** Reforms to strengthen the banking sector are proceeding according to timeline set by the authorities (see Box A), with the passage of legislation providing the framework for the adoption of risk-based supervision in the medium term. This includes the approval of the revised Bank of Lao PDR (BOL) Law which helps improve the BOL's ability to regulate banks in accordance with international standards; and the amended Law on Commercial Banks which specifies enhanced definitions of capital, and implements improved information disclosure and risk management practices based on Basel II standards.

### Box A. Improvements in Banking Sector Regulation and Supervision in Lao PDR[9]

**Lao PDR's has been improving its regulatory and supervisory framework to strengthen its financial system.** The Bank of the Lao PDR (BOL) has drafted a policy document "10-Year Strategic Plan for the Financial System Development of the Lao PDR (2016-2025) and Vision 2030" with a special focus on policy measures for financial system development. Key initiatives include financial instrument development and supervision implementation, where the plan for supervisory development focuses on upgrading the banking supervision system to comply with international banking standards under Basel II principles. Against this backdrop, this Box intends to provide some background knowledge of Basel II regulations, identify challenges of implementing new regulations and provides an update on the development of the Basel II implementation plan in Lao PDR.

**Transition to more risk-based supervision with the adoption of Basel II standards are expected to improve banking sector stability in the medium term.** CAMELS[10] and Basel I have several limitations, such as narrow coverage confined only to credit and market risks. The Basel Committee on Banking Supervision therefore released a new standard known as the Basel II Framework[11] in June 2004, offering a new set of international standards for establishing minimum capital requirements for banks. Moving from relatively simple compliance-based supervision towards more complex risk-based supervision, the Basel II standards aims to ensure that the regulatory capital held by banks better

[9] Prepared by Tanyasorn Ekapirak and Malichanh Chiemsisoulath.
[10] CAMELS is a recognized international rating system that bank supervisory authorities use in order to rate financial institutions based on six factors: capital adequacy, asset quality, management, earnings, liquidity and sensitivity.
[11] International Convergence of Capital Measurement and Capital Standards - A Revised Framework.

reflects the actual risks that banks are undertaking. It also provides a better incentive for banks to improve their risk management systems by allowing banks to use their own models for assessing risks.

**Banks as well as regulators will encounter many challenges in introducing Basel II regulations.** In particular, resource adequacy, supervisory capacity and technical expertise are often the most binding constraints, slowing the speed of Basel II implementation in Lao PDR. Implementing Basel II substantially increases the complexities of banking supervision and requires significant regulator involvements to ensure that banks are complying with the new rules. Many banks in Laos are short of skilled staff who can understand and implement the sophisticated Basel II requirements, which calls for more trainings and development programs. Another important practical constraint is the availability of accurate and reliable data. For example, the standardized approach for credit risk depends on external credit ratings, and without appropriate External Credit Rating Agencies operating within Lao PDR, an effective and acceptable assessment using this approach will be challenging. The internal model-based approaches and value-at-risk model are the most difficult components to implement, requiring extensive historic data. Aside from the technical challenges, some components of Basel II require substantial legal powers by the national supervisors, in particular, authority to enforce prompt corrective actions, the legal mandate to impose higher capital requirements, and sufficient capability to conduct supervision at a consolidated level. Meanwhile, Pillar 3 requires the oversight of confidentiality rules. The board of directors and senior management must also ensure that appropriate review of the disclosures takes place and disclosures have been prepared in accordance with the board-agreed internal control processes.

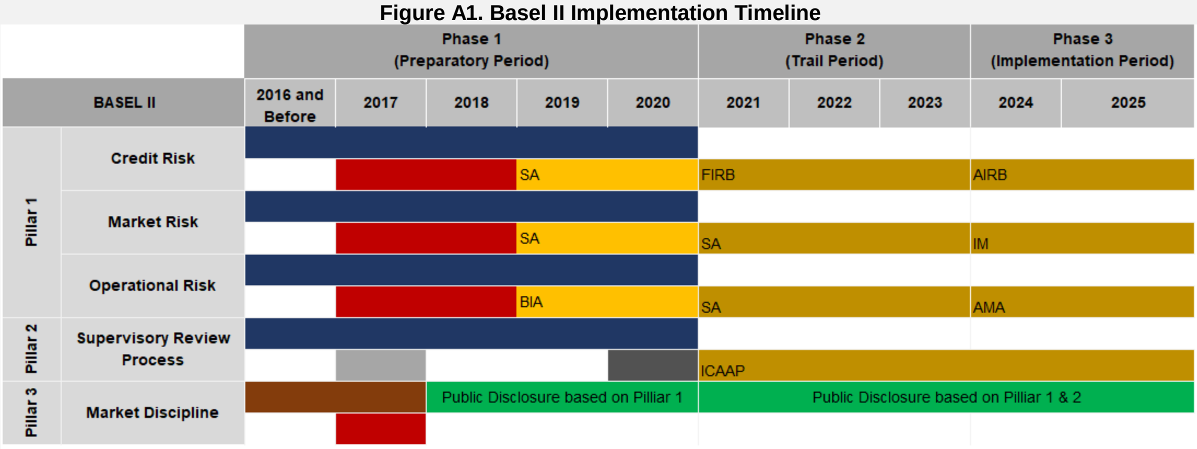
**The BOL has successfully set the legal and regulatory framework for the adoption of key Basel II principles.** In 2017, the BOL initiated a transition of its banking supervision system into the one based on the risk-based principle with new laws and regulations consistent with recent financial developments and international standards. For instance, the BOL amended the Law on Commercial Banks, endorsed by the National Assembly on 7 December 2018, which stipulates that the provision of capital requirements is based on Basel II standards, and issued a set of new regulations on risk management, ICAAP and information disclosure.

**The Basel II is planned to be implemented in three phases.** Figure A1 presents the BOL's plan for the phased implementation of the Basel II. The first phase (2017-2020) focuses on the preparation of Basel II implementation, such as conducting self-assessment, imposing risk assessment methods and implementing the minimum standards on capital requirements - Standardized Approaches (SAs) and Basic Indicator Approach (BIA). Out of 43 banks, 20 were selected to conduct a self-assessment[12] for piloting the gap analysis of Basel Core Principles (BCPs)[13] and minimum standards of Basel II, to assess how far they are from the full compliance with Basel II. Among these 20 banks, the best performing five will be chosen to be part of the first group to fully implement Basel II. Currently, 15 banks have already completed their self-assessment and the assessment reports have been reviewed by BOL. The process of pilot bank selection is still in progress and will be finalized after receiving assessment reports from all 20 banks. In the second phase (2021-2023), the BOL expects all banks are able to fully comply with Basel II minimum standards with a comprehensive legal framework for banking supervision, and plans to start implementing the ICAAP. By the end of this phase, five pilot banks will be required to employ more advanced measurements for capital requirements calculation.[14] In the final phase (2024-2025), the BOL will introduce a new regulation to allow banks to opt for a more advanced approach for capital measurement, to require banks to implement ICAAP and disclose information to the public. The five pilot banks may apply more advanced measurement for capital requirements calculation, which are the Advanced Internal Rating Based Approach (AIRB), Internal

[12] Self-assessment includes (1) credit risk, (2) operational risk, (3) market risk, (4) liquidity risk, (5) ICAAP, (6) interest rate risk, and (7) CAR compared with Basel and BOL regulations.
[13] Banks are divided into three groups (1) local banks, (2) foreign banks whose parental banks have gone through Basel II, and (3) both local and foreign banks, which have not yet ready to implement Basel II. Twenty Banks have been selected from groups 1 and 3 based on their readiness for Basel II implementation.
[14] FIRB for credit risk and SAs for market risk and operational risk assessment.

Models Approach (IM) and Advanced Measurement Approach (AMA) for credit risk, market risk and operational risk assessment respectively.

**Figure A1. Basel II Implementation Timeline**




Remarks:
- Planning and Coducting Basel II implemention framework.
- Defining gaps based on Basel Core Principles.
- Implementing minimum standard of each risk assessment method.
- Achieving/completing Basel II risk assessment methods.
- Improving organisational management, and expanding the responsibilities of boards of directors.
- Reviewing the organisational managment, and assessing the capital requirements by ICAAP.
- Establishing regulations on risk management reporting.
- Disclosing information to the public based on the disclosure requirements of Pilliar 1 and 2.

Pilliar 1: 1) Credit risk includes FIRB and AIRB; 2) Market risk includes SA and IM; and 3) Operionaltional risk includes SA and AMA.

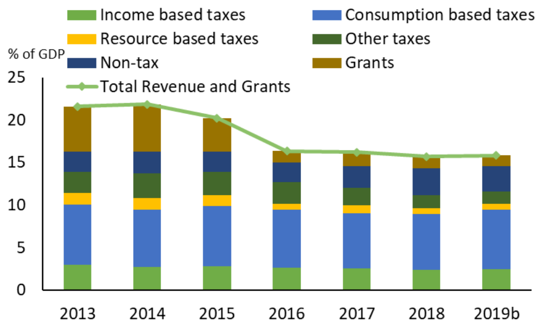
Pillar 2: Supervisory Review Process includes ICAAP.

Source: Bank of Lao PDR

## A.4 Fiscal Sector

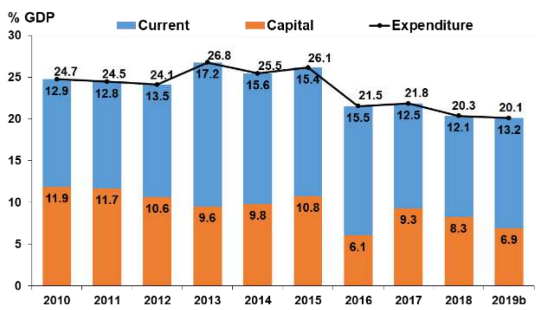
11. **Revenue collection remained weak in 2018.** The tax to GDP ratio fell to 11.2 percent in 2018 from 12.0 percent in 2017.[15] With no major tax reform measure passed in 2018, only excise tax collection grew faster than GDP, driven by higher oil prices. Resource revenues were dampened as lower mining output offset the recovery in copper price, and timber exports declined due to tighter controls. This was only partially compensated by the rise in non-tax revenue which reached 3.0 percent of GDP in 2018 from 2.5 percent of GDP previously, led by higher dividends, interest earnings and other government fees. Lower domestic revenue combined with the 8.4 percent contraction in grants resulted in a drop in total revenues and grants to 15.6 percent of GDP in 2018 from 16.1 percent in 2017 (Figure 15). [16]

**Figure 15. Total Revenue and Grants**




Source: Ministry of Finance

**Figure 16. Current and Capital Expenditure**




Source: Ministry of Finance, AMRO staff projections

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[15] As the major drivers of economic growth such as hydropower and Special Economic Zones (SEZs) are enjoying lengthy tax holidays, the growth of tax revenue continue to lag GDP growth, resulting to a fall in the tax to GDP ratio. (Refer to Selected Issue on Fiscal Revenues in Laos: Trends and Future Options for Reform)

[16] Grants to Lao PDR significantly fell since 2016 due in part to donors' internal policy shift.

12. **Amid subdued revenue collection, current expenditures remained flat and capital expenditures were curtailed.** Current expenditure was maintained at 12.2 percent of GDP in 2018 through tight management of the public wage bill by limiting hiring, freezing wages and allowing only moderate increase in government programs including subsidies (Figure 16). Meanwhile, interest payment continued to rise to 1.7 percent of GDP in 2018 from 1.4 percent in 2017. With the tight current spending control, capital expenditure was likewise reduced to 7.8 percent of GDP as no new projects were initiated. The government continues to review current projects for their viability, with an eye to cutting inefficient and unnecessary projects to streamline investments.

13. **The fiscal deficit narrowed in 2018 and is budgeted to narrow further in 2019 through a combination of revenue raising and cost cutting measures.** Preliminary figures from the government indicate the fiscal deficit narrowed to 4.4 percent of GDP in 2018 from 5.5 percent of GDP in 2017, as expenditure was tightly controlled amid the flat growth in tax collection. The fiscal deficit is budgeted to decline further to 4.3 percent of GDP in 2019. As the revenue collection will remain challenging with major revenue enhancing reforms expected to take effect only from 2020, focus on careful expenditure management remains imperative in order to keep the consolidation path in line with the medium-term fiscal deficit target of 4 percent of GDP (See Box B).

**Box B. Recent Fiscal Reform Initiatives in Lao PDR**[17]

**Recent fiscal reform initiatives focus on more sustainable and broad based growth.** The government endorsed the document titled “Public Finance Development Strategy 2025 and Vision 2030” on 4 July 2017, whose key policy objectives are (i) to develop a more effective, more transparent and fairer public finances, with modern public finance management (PFM) practices; (ii) to explore new revenue sources in order to meet the needs of the National Socio-economic Development Plan (NSEDP); (iii) to create supportive environments for Lao PDR’s graduation from Least-Developed Country (LDC) status by 2020 and (iv) to meet the green growth and sustainable development goals. The fiscal reform committee[18] was established on 24 April 2018 to guide and monitor the effective implementation of the Strategy 2025 and Vision 2030.

**The reform initatives are developed into ten strategies with phased work programmes.** The Strategy 2025 and Vision 2030 presents ten reform strategies such as (i) maintaining macroeconomic stability; (ii) optimizing revenue mobilization; (iii) rationalizing expenditure; (iv) efficient and prudent public debt management; (v) capacity-building and personnel development; (vi) strengthening accounting, audit and financial controls; (vii) upgrading the public financial sector to regional and international standards; (viii) strengthening the legal framework for public finance management (PFM); (ix) international cooperation and integration; (x) enhancing the management of state-owned enterprises. Priority work programmes for Phase 1 (2018-2020) have been under implementation currently, and the work programmes for Phase 2 (2021-2025) and Phase 3 (2026-2030) will be further developed by the fiscal reform committee.

[17] Prepared by Phanomphone Keovongvichith.
[18] This committee is chaired by minister of finance. vice minister of finance is vice-chair, and other members are vice ministers from related ministries including planning and investment, education, home affairs, health, public work and transports, agriculture and forest, science and technology, telecommunication and posts, industry and commerce, and energy and mining, culture and tourism. Deputy Governor of Bank of Lao PDR is also a member.

**Table C1. Work Programmes for 2018-2020**

| Work Programmes for 2018-2020 | |
|---|---|
| 1. Fiscal policy reform | • Readjusting revenue policies and expenditure policies toward fiscal consolidation<br>• Developing public debt management strategy<br>• Enhancing the management of state budget reserves<br>• Developing implementation plan on National Anti-Corruption Strategy<br>• Increasing gradually budget allocation for the Government's priorities[19] and piloting budget allocation for Sam Sang (Three Builds)[20] activities |
| 2. Legal framework in public finance | • Reviewing and revising existing Laws<br>• Developing new Laws<br>• Developing and revising secondary legislations<br>• Improving accounting and independent audit |
| 3. Revenue management reform | • Implementing tax development plan and customs development plan<br>• Developing reform plan for state-owned enterprises(SOEs)<br>• Improving state assets management strategy<br>• Improving administrative fee collection at central level and local level |
| 4. Public expenditure reform | • Reforming state budget expenditure processes<br>• Implementing budget expenditure plan, implementation reporting, and post spending audits<br>• Implementing budget expenditure reform plan at local level<br>• Developing tracking system on public procurement |
| 5. Public finance modernisation | • Developing information, communication and technology (ICT) infrastructure<br>• Improving Government Finance Information System<br>• Preparing for Financial Management Information System<br>• implementation<br>• Implementing Tax Information(TaxRIS) system, ASYCUDA, Smart Tax, Easy Tax systems, Automated Clearing House, Electronic Office (E-Office) system Improving Debt Management system<br>• Developing State Assets Management system<br>• Improving Treasury Single Account (TSA)<br>• Improving payroll system at central level<br>• Improving local public finance management |
| 6. Strengthening the institutional arrangement and development of human resources | • Improving the organisational management<br>• Improving public sector human resource development and management<br>• Providing change management training to prepare for PFM reform |

Source: Public Finance Development Strategy 2025 and Vision 2030

**Government set the medium-term fiscal targets envisaging a gradual fiscal consolidation plan supported by the reform programmes.** The key fiscal targets set for 2018-20 include the followings: (i) revenue at 17-18 percent of GDP, of which domestic revenue is 15-16 percent of GDP; (ii)

[19] Budget allocations to health and education are targeted to achieve 9 percent of total expenditure and 14 percent of total expenditure respectively. In 2016, budget allocation to health sector was about 5.6% of total expenditure, while allocation to education was 13 percent of total expenditure.

[20] Sam Sang is the policy to promote the development in rural areas in the Lao PDR, which was issued in 15 February 2012 . The aims is to build the capacity of the sound and effective local administrations such as provincial, district, and village level in its service delivery, as well as delegate more resources and personnel to local administration. By achieving this, the provinces would play the planning and guiding role (Strategic Planning Unit), while district level would serve a core unit to supervise, assign, monitor, report the implementation of programmes of activities to the villages level (Comprehensively Strengthening Units), and the village level would be equipped with necessary resources and capacity to implement the programmme in its localities (Development Units). The expected outcome would result in the further development at the village level and rural areas. Two provinces in southern parts such as Saravan and Sekong have been selected to be pilot provinces for the implementation.

expenditure at 22-24 percent of GDP; (iii) the budget deficit within 5 percent of GDP; (iv) public debt below 65 percent of GDP. Based on the implementation outcomes, the government will review and revise the major fiscal targets for the 9th Socio-Economic Development Plan (2021-2025).

**Focused efforts have made some progresses in improving public finance legal framework and rationalizing expenditures.** Among many reform programmes, authorities have been able to make some progress in their legal and institutional framework. In particular, aimed at enhancing revenue collection, a new VAT implementation instruction was issued and the VAT law was revised, reducing VAT exemption list, expanding taxpayer base, and introducing technology in revenue collection. In addition, the government introduced new regulations on administrative expenditures and strengthened the inspection of capital expenditure, to contain budget expenditure growth and rationalize current spending. All these improved institutions are expected to contribute to gradual enhancement in fiscal situation going forward, further facilitating the implementation of fiscal reform programmes.[21]

14. **The rising level of debt and increasing debt service burden continue to weigh down on the fiscal position.** According to official figures, public debt increased to 57.4 percent of GDP as of end-2018 from 55.4 percent of GDP in 2017.[22] The rising debt stock continues to put pressure on the fiscal position, as gross financing needs (fiscal deficit and amortization) increased to 9.6 percent of GDP in 2018 compared to 5.1 percent in 2014.[23] With increasing non-concessional loans, interest payment has climbed to 1.7 percent of GDP (equivalent to 8.4 percent of total expenditure) in 2018 from 0.9 percent of GDP (3.5 percent of total expenditure) in 2014. In addition to multilateral and bilateral loans from development partners, the fiscal deficit was financed by issuing bonds in the Thai market as well as in the domestic market. After a successful launch of a trading platform for government bonds at the Lao Stock Exchange, the ministry of finance issued LAK285 billion in local government bonds in December 2018.[24]

## B. Risks, Vulnerabilities and Challenges

15. **The economy's path towards robust growth and sustainable development remains vulnerable to rising domestic and external risks.** As a small developing economy with expanding linkages to global value chains (GVCs) and financial markets, Lao PDR needs to closely monitor and address growing vulnerabilities and challenges. On the domestic front, setbacks in fiscal consolidation and further deterioration in fiscal sustainability can have a substantial negative impact on the policy space needed to maintain macroeconomic stability. On the financial sector, delays in resolving the remaining arrears related to past government projects could prolong the uncertainty and weigh down credit and economic growth as banks hold back fresh lending. On the external front, a sharp tightening in global financial conditions

[21] Government is committed to continue its reform efforts in 2019 and 2020. Ministry of Finance is preparing 3 draft laws – income tax law, tax administration law, and excise tax law – to be tabled for National Assembly's consideration in 2019, which are expected to contribute to fiscal consolidation plan.
[22] The increase in the authorities' debt figure for 2018 was mainly due to the recognition of past arrears related to government projects, which involves the transfer of the outstanding debt to the government, thereby taking off the weight of this legacy debt from banks' balance sheets.
[23] The increase in gross financing needs was mainly driven by higher amortization payments, which in 2018 was higher by 3.7 percent of GDP when compared to 2014 (amortization payment had been steadily rising since 2014 when it was equivalent to 1.5 percent of GDP to the current level of 5.2 percent of GDP). Meanwhile, interest expense and primary balance increased by 0.8 and 0.2 percent of GDP, respectively, for the same five year period.
[24] The initial target is to issue LAK1000 billion of domestic government bonds through the LSX, with the remaining LAK715 billion to be issued in 2019.

could exert significant pressures on exchange rate and debt payments. Moreover, policy shifts and a growth slowdown in major trading partners can have adverse implications on the Lao economy, particularly given significant exposures to China, Thailand and Vietnam via channels such as trade, investments and tourism.

### B.1 Increased Fiscal Vulnerability from High Debt Level and Debt Profile

16. **Fast-rising public debt tends to increase debt service burden and the probability of debt distress.** As a low-income country with limited revenue sources, Lao PDR's government has been dependent on external borrowings to help develop the economy. However, this led to rapid accumulation of public debt with the debt-to-GDP ratio on the high side in the region. Although about two-thirds of external debt are concessional, the public debt profile has become more vulnerable to external shocks with the increasing proportion of non-concessional borrowing, including rollover risk on bonds issued in the Thai market. Also, this increasing commercial loan proportion tends to increase the debt service burden. Moreover, with more than 80 percent of public debt denominated in foreign currency, the debt portfolio is highly vulnerable to exchange rate shocks.

17. **The challenging revenue conditions and increasing spending pressure may jeopardize the government's fiscal consolidation plan.** Both revenues and grants fell in the past five years due to a slowing mining sector and a shift in policy focus among development partners.[25] This downward trend in mining sector revenue is expected to continue even with the recovery in commodity prices, as the two major mines that account for almost 80 percent of production are set to wind down operations by 2020 due to a depletion in mineral deposits. Meanwhile, revenues from the hydropower sector remain low at around 1 percent of GDP, mainly due to the long concession period, and expected to rise to around 2 percent of GDP by 2024 when corporate income tax payments from big hydropower projects are scheduled to rise according to the concession agreement. On the expenditure side, pressures from mega infrastructure projects could also introduce stress to the fiscal position, as the government is required to provide counter-part funding or equity stakes, such as for the Lao-China Railway and Vientiane-Vang Vieng highway.[26] In addition, spending needs for development priorities will continue to increase, in order to address health, education and infrastructure issues for long-term sustainable development. Given the narrowing margin to further cut discretionary spending and the increasing debt service, the policy room to maneuver grows tighter.

18. **Contingent liabilities pose risks to the fiscal consolidation plan.** Amid the government's recent efforts to centralize debt management, the government's explicit

[25] Grants dropped to an average of 2.1 percent of GDP during the period 2015-2018 from an average of 5.8 percent of GDP in 2010-2014. Meanwhile, revenue from the mining sector has steadily fallen from its peak of 3.5 percent of GDP in 2011 to less than 1 percent of GDP in 2018 as commodity prices fell and output declined.

[26] For the Lao-China Railway, the Lao government's direct exposure is through its equity share in the joint venture company equivalent to USD720 million (12 percent of the total project cost of USD6 billion). This equity share will be financed by a USD470 million loan from China EXIM bank, with the remaining USD250 to be provided through the budget at USD50 million per year during the 5-year construction period of the railway. Meanwhile, the construction of the Vientiane-Vang Vieng highway is set-up as a Build-Operate-Transfer (BOT) project, with an estimated cost of USD1.3 billion, through a joint venture company called Laos-China Joint Expressway Development Company Limited. China will hold 95 percent of the company through the Yunnan Construction and Investment Holding Group (YCIH), with the Lao government holding the remaining 5 percent.

contingent liabilities have been rising in past years through direct government guarantees and on-lending, particularly to the electricity sector.[27] While hydropower projects to export electricity are generally viable with guaranteed revenue via long-term power purchase agreements (PPAs), certain projects that cater to the domestic market could face the risk of electricity oversupply. Meanwhile, the increase in public debt in 2018 was due in part to the recognition of local government arrears for infrastructure projects in the past. Ongoing efforts to settle remaining arrears related to past government projects may further increase public debt level, but are necessary in order to resolve the legacy NPL issue and strengthen bank balance sheets. In addition, recent mega infrastructure projects can be another source of sizeable implicit contingent liabilities which require close monitoring and effective management.[28]

### B.2 Capital Buffer and Remaining Arrears

19. **Most financial institutions appear to have sound financial indicators, but pockets of vulnerabilities in the financial system need attention, including the low capital adequacy ratios in some banks and remaining arrears related to past government projects.** Although the system-wide Capital Adequacy Ratio (CAR) is significantly above the Basel minimum requirement of 8 percent, some banks, particularly the two smaller state-owned banks remain vulnerable with low or insufficient capital buffer levels. Enhancing bank capital is especially important as the BOL has been upgrading its regulatory and supervisory regime by implementing Basel II regulations. In this regard, the revisions in the calculation of risk-weighted assets (RWAs) will directly impact on the required level of CAR[29], with low or undercapitalized banks finding it more difficult to meet Basel's minimum capital requirement. Risk management systems in banks likewise need to be upgraded to mitigate the risks from new loans and smoothen the transition to Basel II.

20. **The resolution of arrears related to past government projects is ongoing and requires closure to improve the health of bank balance sheets.** The government's bond issuance of LAK3,200 billion in December 2018 resolved only part of the arrears related to past government projects, and the remaining arrears still needs to be settled.[30] Although there is regulatory forbearance on the remaining arrears by classifying them as "special mention" loans, proper closure on the process is needed. Otherwise, uncertainty will remain and continue to weigh down on the banking sector's balance sheets, holding back bank lending, which has slowed to single-digit levels in 2018.

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[27] According to the World Bank Lao PDR Economic Monitor (2018), more than half of public external debt can be traced to loans to the power sector, either directly as government debt, or on-lent to state-owned companies in the power sector, mostly to EDL. In its 2017 report, World Bank also noted that the debt-to-equity ratio of EDL has increased rapidly due to hydropower and transmission line projects, reported to reach around 2.8 in 2015 from 1.6 in 2013.

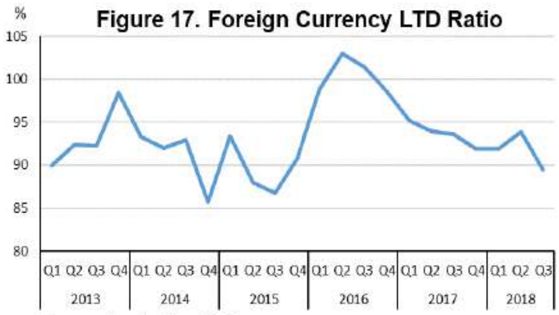
[28] Although the government did not provide explicit government guarantees to large infrastructure projects such as the Lao-China Railway, it may still be under significant pressure to partially cover operational losses and debt servicing costs, particularly in the initial years of operation.

[29] CAR = Capital (Tire 1 + Tier 2)/ RWAs

[30] The following project conditions must be satisfied for such settlement: a) the project must be on-budget and approved by the National Assembly; b) certified as fully completed; and c) pre-financed by loans from commercial banks certified by commercial banks and the Bank of Lao.

### B.3 Uncertain Global Financial Conditions and Vulnerable External Position

21. **Financial sector stability and fiscal sustainability remain susceptible to large exchange rate depreciation.** A sharp depreciation of the LAK would have cross-cutting impact across the economy due to dollarization and high reliance on external funding. Given the partial dollarization in the economy, wherein over half of deposits and credit are in foreign currencies, sudden large depreciation of LAK could lead to balance sheet mismatches in corporations and banks. Individual firms may face significant pressure in case of a massive exchange rate depreciation depending on their sources of revenues. In particular, companies that depend on local currency sources of income are more exposed to currency risks, as there are no proper hedging instruments available in Laos. For the financial sector, the risk of overleveraging in foreign currency has abated with the FX loan-to-deposit (LTD) ratio on a downward trend since the peak in 2016 (Figure 17). In addition, a sharp depreciation would likewise have serious implications on the fiscal accounts due to the high proportion of foreign currency denominated debt, resulting in higher debt and debt servicing costs.

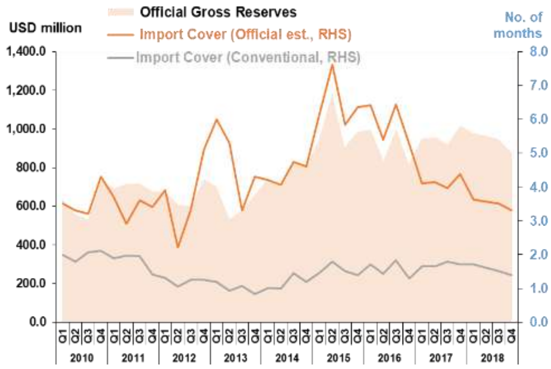


Source: Bank of Lao PDR

22. **The external position continues to be vulnerable to shocks given the low level of international reserves.** Amid the challenging external environment in 2018, the BOL's ability to smooth out exchange rate volatility is limited by low international reserves (Figure 18). With the heightened volatility in global financial markets during the second half of 2018, exchange rate pressure on the kip was manifested in the widening gap between the parallel and commercial exchange rates. The gap peaked at 4 percent in the second week of August as US dollar liquidity tightened. The gap has since narrowed to less than 1 percent as global financial markets stabilized towards the end of 2018, with the parallel rate and the commercial rate converging (Figure 19).[31] To some extent, the widening gap reflects the growing imbalance between the demand and supply for foreign exchange amid rising fiscal and current account deficits, which cannot be fully accommodated by the foreign reserves. The widening gap creates market distortions and leads to market expectations of an exchange rate correction, possibly resulting in increased precautionary demand for foreign currency and greater depreciation pressure on the kip.

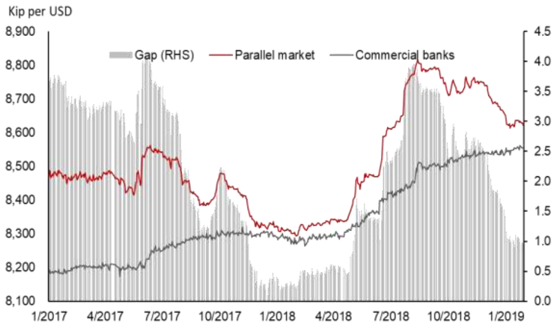
[31] The narrowing of the gap was also helped by the increase in supply of foreign currency through the government bond issuance in the Thai market and gradual depreciation of the official rate.

Figure 18. International Reserves



Source: Bank of Lao PDR

Figure 19. Lao kip to US dollar

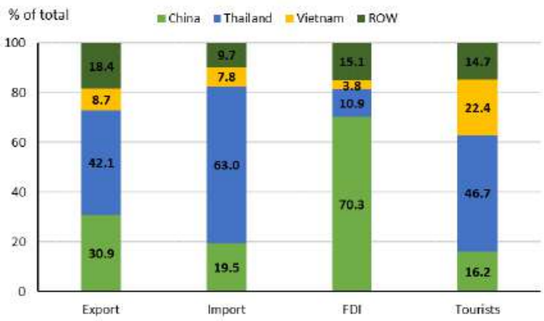


Source: Bank of Lao PDR

## B.4 Growth Slowdown and Policy Shifts in Neighboring Countries

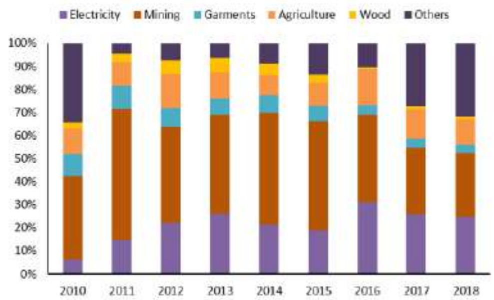
23. **The close economic and trade linkages with China, Thailand and Vietnam make Lao PDR vulnerable to spillovers from these countries.** As a landlocked country, the Lao economy maintains close economic ties with its neighboring countries, particularly Thailand, China and Vietnam. A growth slowdown in these countries constitutes a potential major headwind to trade, investment and tourism in Laos. In particular, a major slowdown in China would have marked macroeconomic implications for Laos. In the past three years, China was the second key trading partner and the third largest source of tourists for Laos, and the number one source of FDI, accounting for over two-thirds of investments in the country (Figure 20).

Figure 20. Exposure to Neighboring Countries (2016-2018)



Source: Bank of Lao PDR

Figure 21. Export Share by Major Categories



Source: Bank of Lao PDR

24. **Policy shifts in neighboring countries have significant implications for the Lao economy.** Given the high reliance of Lao PDR on its neighboring countries for FDI, tourism and trade, their domestic policy shifts can have substantial effects on the Lao economy. For example, shifts in energy policy and electricity demand, particularly in Thailand, to which 80 percent of Lao PDR's electricity production is exported, would have significant consequences on the performance of its hydropower sector. Electricity exports, which now accounts for a quarter of total exports, are expected to continue increasing with the scheduled commencement of operations of a number of large hydropower projects, overtaking mining in the coming years as Lao PDR's most important export item. (Figure 21). However, future

prospects for electricity exports rest critically on the energy import policy of neighboring countries. Most recently, changes in Thailand's Power Development Plan may lead to lower export price of electricity to Thailand.[32]

## B.5 Structural Challenges

25. **Significant reliance on natural resources has exposed the economy to external shocks and inhibited the growth of the manufacturing sector.** Lao PDR has grown rapidly in the past 20 years, driven by foreign investments in the resource sector, particularly in mining and hydropower. However, the combination of real exchange rate appreciation[33] and higher returns in the resource sector have stunted the growth of the tradeable non-resource sectors, particularly manufacturing, which accounted for less than 10 percent of GDP over the past 20 years. Given the country's high dependence on the resource sector, particularly mining, economic growth remains highly susceptible to commodity price shocks and the risk of eventual full depletion of minerals in existing mines.

26. **Raising government revenue has been challenging due to the prevailing tax structure.** The tax structure is dominated by consumption taxes, constituting more than half of total tax revenues, while income-based taxes account for around 20 percent. Tax authorities are working to raise income-based taxes, but the biggest drivers of economic growth – the hydropower projects and the companies in SEZs – are often granted generous tax exemptions spanning many years. The tax structure coupled with tax exemptions have contributed to a downward pressure on the tax to GDP ratios. Meanwhile, resource revenues provide support to the fiscal position, but these have been falling from about 4 percent of GDP in 2011 to around 2 percent in recent years, mainly due to declining mining revenues as deposits in the two largest mines are about to be depleted. (Refer to Selected Issue on Fiscal Revenues in Laos: Trends and Future Options for Reform)

### *Authorities' Views*

27. **The authorities generally concur with AMRO's assessment on the risks and challenges facing the economy.** The authorities acknowledge that the high and rising public debt is a key challenge that the government will need to address in a firm and steadfast manner. Meanwhile, the risk of oversupply of electricity in the domestic market and waning electricity demand from Thailand is expected to be mitigated by new electricity export agreements with other neighboring countries such as Cambodia and Vietnam. External factors have likewise dampened economic growth, but the ongoing structural transformation of the

[32] Laos has secured an MOU to export 9,000 MW of electricity to Thailand. Currently Laos has already utilized 6,000 MW of this agreement to supply electricity to Thailand on a "firm commitment" basis which has a higher tariff compared to "non-firm" power supplied to Thailand. Tariffs for supplying electricity on a "firm commitment" basis are higher as it is a stable source of electricity, as opposed to "non-firm" supply of electricity, which happens seasonally (during the rainy season) when there is usually an excess of hydropower electricity generated. Due to the change in the Power Development Plan of Thailand, the remaining 3,000 MW that Laos can supply to Thailand on a "firm committed" basis may only be tapped by 2026.

[33] The massive inflow of foreign investments and robust resource exports caused the real exchange rate to appreciate by about 40 percent since 2008.

economy towards more diversified drivers of growth is expected to reduce the risks of over reliance on particular sectors or countries in the medium term.

## C. Policy Discussion and Recommendations

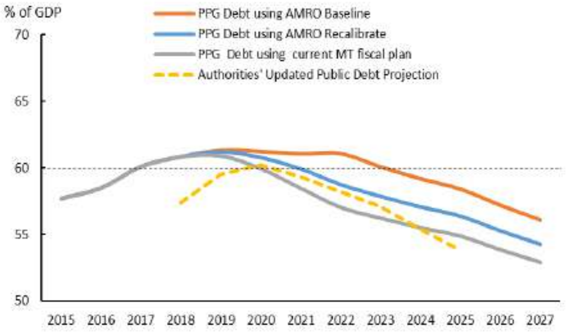
### C.1 Ensuring Fiscal Sustainability

28. **Amid heightened concerns about fiscal sustainability, building confidence by making progress in line with a feasible medium-term fiscal consolidation plan is essential.** The authorities' commitment towards fiscal consolidation to reverse the trend of rising public debt to GDP is commendable. Given that the consolidation targets were missed by a substantial margin in recent years, achieving the consolidation targets can be more important than setting ambitious targets, to gain market confidence. In this regard, recalibrating the fiscal consolidation path with more realistic targets and ensuring their achievement will help to build credibility and confidence in fiscal management.[34] Authorities need to substantiate the fiscal consolidation plan with carefully coordinated tangible policy measures which require strong commitment and support from the whole public sector.

29. **Recalibrating the fiscal consolidation plan is recommended to allow for more gradual adjustments in the fiscal deficit and public debt, and to enable greater focus on promoting growth by reprioritizing resources towards development spending.** It is advisable that the authorities take strong measures to bring debt below 60 percent of GDP in the medium term. Figure 22 illustrate AMRO's projections of public and publicly guaranteed debt (PPG) based on the World Bank and IMF's debt statistics and Table 1 summarize AMRO's fiscal projections under these scenarios. Under AMRO's baseline scenario, the average fiscal deficit in the medium term is at 4.6 percent of GDP, taking into account efforts to streamline expenditures and revenue reforms up to 2018. Meanwhile, under the current medium-term fiscal consolidation plan of the authorities a steeper decline in the debt-to-GDP ratio can be seen, due to a frontloaded boost in tax revenues from the current tax reform and the additional increase from planned future tax reforms, combined with significant cuts in current and capital expenditure. In AMRO's recalibrated scenario, a progressive increase in tax collection is assumed with the benefits generated by major tax reforms taking effect only from 2020 onwards. In addition, slightly lower current expenditure while preserving capital expenditures, along with the government's original investment plans of between 7-8 percent of GDP, is also incorporated into AMRO's recalibrated scenario, and assumed to provide additional support to the country's growth and development (Table 1). Under AMRO's recalibrated fiscal adjustment scenario, PPG debt is expected to decline below 60 percent of GDP by 2021, one year later when compared to the current medium-term fiscal consolidation plan.

[34] The authorities' original plan was to progressively lower the fiscal deficit to 5.0, 4.7 and 4.4 percent of GDP in 2016, 2017 and 2018, respectively. However, the actual fiscal deficits stood at 5.2, 5.5 and 4.4 percent of GDP for the respective years.

**Figure 22. Public Debt Projection**




Note: AMRO's public debt estimates include government guarantees. For comparison, the authorities' own updated public debt projection is included in dashed lines.
Source: Ministry of Finance, AMRO staff estimates

**Table 1. Fiscal Consolidation Scenarios**

| (in percent of GDP) | AMRO Baseline | AMRO Recalibrate | Authorities' MT Fiscal Plan |
|---|---|---|---|
| | 2019-22 | 2019-22 | 2019-22 |
| Revenue and grants | 15.2 | 15.8 | 16.1 |
| Grants | 1.0 | 1.0 | 1.0 |
| Expenditure | 19.8 | 19.8 | 19.5 |
| Current | 12.8 | 12.5 | 12.6 |
| Capital | 7.0 | 7.3 | 6.9 |
| Fiscal balance | -4.6 | -4.0 | -3.4 |
| | | | |
| GDP growth | 6.7 | 6.9 | 6.6 |

Source: Ministry of Finance, AMRO staff estimates

30. **Stronger revenue efforts are essential to achieve fiscal consolidation targets.** With structural constraints to increasing tax revenues, greater and sustained efforts are needed to raise revenue through improvements in tax administration and the passage of tax reforms, such as a new property tax, excise tax rate hikes on selected items and an improved tax collection system, particularly for VAT. Parallel to this, efforts to broaden the profit and income tax base should be accelerated through continued updating of the taxpayer registry to bring more businesses under the tax net. In addition, a comprehensive review and enhanced management of tax expenditures such as exemptions and tax holidays could be initiated to ensure the effectiveness and validity of such incentives and minimize leakages on government revenues. However, the impact of revenue raising measures on other policy initiatives needs to be carefully assessed, such as on poverty-reduction and promotion of micro, small and medium-sized enterprises (MSMEs). The negative impact of increased taxes on these sectors needs to be balanced by targeted social programs or enhanced industrial development programs (see Selected Issue on Fiscal Revenues in Laos: Trends and Future Options for Reform).

31. **Improving expenditure planning and project-selection are important to enhance spending efficiency and support the consolidation plan.** Given the challenging revenue condition, the government's initiatives to improve expenditure planning to be better aligned with fiscal resources are in the right direction. Enhancing project-selection process is another key element to better allocate resources to those with the highest economic or social returns, boosting the long-term growth potential of the economy. Efforts to centralize and streamline the decision-making process, and enhance the transparency and accountability of the budget management will likewise help the government improve fiscal resource management. Above all, a strong commitment to implementing these initiatives is crucial to successfully achieve the fiscal consolidation plan.

32. **Better management of public debt and contingent liabilities needs to be a crucial part of fiscal consolidation efforts.** Amid rising concerns over fiscal sustainability, enhancing debt management is increasingly important to support the implementation of the

medium-term fiscal consolidation plan. In particular, the changing profile of the debt portfolio with an increasing proportion of borrowings through bond issuance in the capital market has rendered public debt more vulnerable to external shocks and it has become more challenging to manage related risks. In this regard, the passage of the Public Debt Management Law in June 2018 is a welcome development, and provides the overarching framework that will lead to improved debt management (See Box C). In operationalizing the law, upgrading of the institutional and human resource capacity is equally important for effective debt management under this new framework. The authorities' efforts to reduce foreign commercial borrowing to finance the deficit must continue, by developing a deeper and more liquid domestic bond market as a ready source of financing for the government. Another key priority is enhanced monitoring and management of contingent liabilities. In this regard, the recent progress in clearing debt arrears is commendable, and establishing proper institutional arrangement is recommended to effectively limit the creation of new contingent liabilities and to adequately manage the risks related to existing contingent liabilities. Although the current debt level is below the debt ceiling of 65 percent of GDP, additional efforts are needed to bring it below 60 percent of GDP to enhance fiscal buffer.

### Box C. Upgrading the Debt Management Framework in Lao PDR[35]

**Public debt management in Lao PDR is undergoing essential legal framework reform**. As part of forming its long-term debt management strategy, and to be in line with the implementation of Vision 2030,[36] Lao PDR's National Assembly enacted the Public Debt Law in June 2018, paving the way for improved management of public debt. Prior to the passage of the law, public debt management in Lao was conducted on a yearly basis through the annual State Budget plan. In addition, the debt management function was fragmented between the central and municipal governments due to the lack of an overarching legislation on public debt management. This fragmented approach had led to municipal governments spending outside the approved Budget plan and acquiring significant amounts of debt to do so, which eventually became arrears.

**The passage of the Public Debt Management Law provides a necessary framework for better public debt management, with the following key features:**

a. **Establishing a legal basis for a comprehensive set of public debt management tools and indicators**, including an obligatory ceiling of public debt-to-GDP ratio and supporting secondary legislations such as the five-year public debt management strategy (tentatively targeted for approval by June 2019), and the annual borrowing and repayment plan. These measures are expected to contribute to a strengthening of public debt management and lowering of public debt-to-GDP ratio in line with Vision 2030.
b. **Centralizing the management of public investment related borrowings**. Prior to the Public Debt Law, municipal governments could carry out investment projects without prior explicit approvals from the central government, which is one of the main causes of the current arrears related to past government projects. The new law mandates the Ministry of Finance to compile a list of all public investment projects and programs (including government guaranteed projects) and to report to the Prime Minister for consideration and approval. Municipal governments are no longer able to make debt-borrowing decisions on their own, and the Ministry of Finance is given the power to stop any project not included in the Budget Plan. This mechanism will also contribute to better management of public investment projects as the

[35] Prepared by Manh Duc Nguyen.
[36] Vision 2030 targets the public debt to be kept below 65 percent of GDP.

Ministry of Finance will be able to review and supervise all public investments, promoting effective use of loan proceeds in general.

c. **Tightening regulations related to government borrowings**. According to the new law, all investment projects with total invested value above LAK400 billion (about USD50 million) are required to seek approval from the National Assembly (Article 15). In addition, the Ministry of Finance is mandated to analyze terms and conditions of all proposed public investment projects, and to evaluate embedded risks, to explore and compare potential funding sources from creditors and to facilitate negotiations with creditors, before submission to the Prime Minister and National Assembly for approval. These regulations clearly mandate the Ministry of Finance to acquire project financing on the best possible terms. The regulations are expected to enhance the decision-making process with regards to government borrowing and to restrict indiscriminate borrowings at unreasonable cost.

d. **Enhancing cash flow management to ensure repayment of public debt obligations through establishment of a contingency fund**. According to the Public Debt Law, the Ministry of Finance will open a contingency account (a sinking fund) that will serve as a liquidity buffer for the repayment of principal, interest and other obligations that arise from government loans, government guaranteed loans, and other issuance of debt instruments (Article 45). The operational principles and specific amount of the fund shall be regulated in a separate guideline that is currently being prepared by the authorities, and is expected to be submitted to the Prime Minister for his approval.

e. **Enhancing transparency and accountability with regards to public debt data disclosure and dissemination**. According to the law, the Ministry of Finance is the focal agency to coordinate with the Ministry of Planning and Investment, Bank of Lao PDR, and foreign creditors, to compile public debt data. This data can be used for reporting and information disclosure to international organizations to implement the commitment of Lao PDR. In addition, the Ministry of Finance is also responsible for submitting reports to the Prime Minister and National Assembly on the current public debt position, and to propose policy directions and strategies with regards to enhancing the management of debt on a yearly basis (Article 49 to 52). Prior to the law, such a report on the status of public debt was not an integral part of state budget reports.

**Following the passage of the Public Debt Law, the next priority is to prepare a medium-term debt management strategy.** The strategy is expected to be approved by the Prime Minister and to take effect at the end of 2019. The detail contents of the strategy have not been reported yet.[37]

### *Authorities' Views*

33. **The authorities' commitment to fiscal discipline continues to strengthen with more focus on revenue generation and expenditure efficiency to support fiscal consolidation efforts.** To help boost revenues, authorities have actively adopted modern technology and sought to enhance staff capacity to improve tax administration. Authorities are likewise setting out on a comprehensive tax reform program to revise the income tax law, excise tax law and tax administration law to help improve tax revenues. In this regard, authorities are targeting a medium-term fiscal deficit of around or below 3 percent of GDP. In terms of expenditure and debt management, the proclamation of the Fiscal Strategy 2025 and

[37] However, this strategy document is expected to set some specific debt safety indicators such as an obligatory threshold for public debt-to-GDP ratio, target structure of public debt portfolio and the medium-term borrowing plan, etc

Fiscal Reform Vision 2030 as well as the passage of the Public Debt Management Law attest to the authorities' commitment to establish a sound and modern fiscal framework.

### C.2 Enabling Supportive Monetary Policy and Flexible Exchange Rate

34. **Enhancing liquidity in the banking system is necessary to support the non-resource sector and promote diversification of the economy.** Efforts to ease the liquidity constraints in the banking sector are welcome, particularly the removal of the interest rate ceilings as this will attract more deposits into banks and promote a more efficient allocation of credit through market-based mechanisms and careful evaluation of risks and returns.[38] With the growth of credit to the private sector trending downwards and at a 10-year low of 4.7 percent as of end-December 2018, credit remains tight constraining the development of the non-resource sector. To this end, the government may consider additional targeted easing measures to ensure sufficient liquidity in the banking system and to channel enough credit to the priority sectors.[39] To maintain macroeconomic stability, such liquidity enhancing measures need to be complemented by strong risk management and supervision of banks to maintain soundness of the financial system.

35. **Exchange rate management requires a careful consideration of the prevailing internal and external balances, together with higher international reserves.** Given the partially dollarized nature of the Lao economy, maintaining macroeconomic stability through careful exchange rate management is one of the key policy priorities. In this regard, the authorities need to further build up international reserves to effectively manage FX volatilities and limit the gap between the official and parallel exchange rates. Building and maintaining a healthy level of international reserves is a key prerequisite for the BOL to be able to effectively contain external shocks. In light of the challenges in building international reserves, allowing a higher level of flexibility in the kip's movements is also recommended. A more flexible exchange rate will require enhancing prudential regulations to help reduce FX related risks in the private sector, and encourage the development of market-based risk management and assessment capabilities. In addition, the banking sector, particularly foreign banks, need to play an active role in developing the foreign exchange and interbank market.

#### *Authorities' Views*

36. **The BOL continues to focus on its mandate of maintaining a stable exchange rate and facilitating the flow of credit in line with the national socio-economic development plan.** The central bank will continue to conduct prudent monetary policy and maintain the stability of the Lao kip that is supportive of economic growth while maintaining sound economic fundamentals. The authorities will continue to manage the exchange rate

[38] The supply of credit and ability of banks to lend were seen as significantly constrained under the interest rate ceiling as banks were not able to utilize proper risk assessment and management tools to lend to the full spectrum of customers, thereby focusing credit on the limited low risk customers only. With the removal of this policy, authorities intend to free up such constraints and target greater provision of credit by banks to local businesses including micro, small and medium size enterprises (MSMEs). However, the impact of the removal of interest rate ceilings on deposit and lending is yet to be observed, as it is expected to take full effect in the coming months.

[39] Prime examples are government initiatives to enable MSMEs to access more finance by coursing concessional loans from the World Bank and China Development Bank to companies that seek to grow their business or boost production.

within the existing band.[40] The gap between the official and parallel exchange rate arises due to multiple causes including fluctuations of key currencies, limited foreign exchange supply and thin markets. Thus the BOL is committed to the further development of the foreign exchange interbank market which will allow competitive pricing, deeper markets and greater exchange rate flexibility in the future. Amidst the decline in credit growth, authorities have deployed expansionary monetary policy to help support economic growth. The impact of the removal of interest rate ceilings on financial and economic conditions still needs to be assessed, with the central bank prepared to initiate further loosening policies to boost credit if needed.

## C.3 Resolution of Arrears and Enhanced Buffers for Banks

37. **Recent progress in reducing financial sector vulnerabilities is commendable, and sustained efforts are needed to resolve the remaining arrears and strengthen bank balance sheets.** The recapitalization of the Banque Pour Le Commerce Exterieur Lao (BCEL) in 2017 has enabled it to meet the regulatory capital requirement, while the restructuring of the other two state-owned banks needs to be speeded up. The resolution of remaining arrears related to past government projects will help strengthen banks' balance sheets. For those loans that will not be taken over by the government, a well-planned gradual write-off combined with recapitalization may be necessary to minimize the negative impact and rehabilitate the banks. In addition, clear communication and higher transparency will help to build market confidence and public support.

38. **Continued progress is needed in enhancing bank supervision and regulation.** The passage of the New Commercial Bank Law is a welcome progress which is expected to strengthen banks' capital buffer, while moving towards risk-based supervision and transitioning to Basel II standards will fortify the soundness and stability of the financial system. With regards to the lifting of all restrictions on foreign currency lending in 2018, it is recommended that the BOL further enhance monitoring and supervision to contain currency mismatch related risks. In this regard, the banking sector also needs to strengthen its ability to absorb shocks by maintaining an adequate capital level and limiting the currency mismatch risks.

### *Authorities' Views*

39. **Banking reforms and restructuring are proceeding according to the timeline, while the resolution of arrears related to past government projects is ongoing.** The reforms to the regulatory framework for banks towards the implementation of Basel II standards and risk based supervision are expected to enhance financial stability, and are proceeding well according to the medium-term timeline set by the BOL. Focused measures to restructure the two smaller state-owned commercial banks are expected to be completed this year, as significant strides have already been taken to overhaul the management and improve

[40] The BOL maintains an annual exchange rate band of +/- 5 percent of the Lao kip against major currencies, particularly with the US dollar.

the profitability of these banks. With regards to the remaining arrears, the government is still in the process of evaluating the individual projects that took loans from banks with regards to their eligibility to receive payment.

## C.4 Enhancing Structural Reform

40. **Policy efforts toward structural reforms and economic diversification need to continue to enhance growth potential and economic resilience.** Investments in mining and hydropower have enabled the country to grow rapidly in the past 15 years. However, it has also led to the current economic structure that is highly reliant on the resource sector. To improve economic resilience, diversifying the economic growth base is essential. This can be done by developing non-resource sectors such as manufacturing, tourism, and agro-based industries. As a land-locked country with a limited supply of skilled labor and a small domestic market, attracting FDI into non-resource sectors requires a strong government commitment and policy support to improve the business environment. However, the provision of public goods such as infrastructure and health services remains limited mainly due to fiscal resource constraints, thus increasing the overall cost of doing business in Laos. Therefore, progressive provision of essential public goods based on the national plan is necessary. For existing and upcoming large infrastructure investments, the government needs to clearly lay out plans and guidelines to help the private sector align their business strategies with the national blueprint. This, in turn, will lower uncertainty and encourage greater private sector participation, thereby maximizing returns on these projects as well as ensuring cross-sector participation in national development. The additional revenue that the government can generate from greater private sector participation will help alleviate the cost of the projects and facilitate their sustained contribution to the development of the country. In addition, institutional reforms and upgrading of current regulations and procedures to create a more conducive environment, can greatly improve Lao PDR's ease of doing business and facilitate new FDI inflows from various countries.

***Authorities' Views***

41. **The mid-term review of the socio-economic plan for the country indicates both important progress in key indicators as well as remaining challenges.** The government has undertaken an assessment of the implementation of the 8$^{th}$ National Socio-Economic Development Plan 2016-2020 (8$^{th}$ NSEDP 2016-2020) to take stock of key results so far and identify challenges to enable more focused efforts to achieve the goals for the remainder of the plan. Efforts to improve social development have been progressing, with enhanced education and health indicators. Environmental initiatives have likewise progressed, with enhanced legislative and regulatory frameworks for water management, forest governance and land classification and zoning. For the remainder of the plan, the focus will be on enabling quality investment, particularly given the tight fiscal position of the government. This will be achieved through enhanced project selection and monitoring. The role of the private sector in boosting growth will also be emphasized, through the promotion of quality private sector investment,

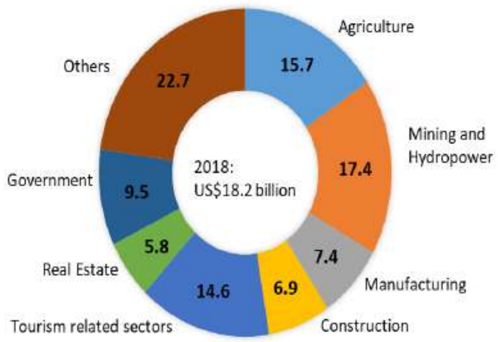
support for small and medium-sized enterprises (SMEs) and facilitating a conducive environment for business and investment. [41]

[41] The Prime Minister's office issued Order No. 2 on May 2018 directing related government ministries and offices to improve and monitor Ease of Doing Business indicators in Lao PDR, particularly starting a business, dealing with construction permits, getting electricity, registering property, getting credit, paying taxes, enforcing contracts and trading across borders, among others.

## Appendix 1. Selected Figures for Major Economic Indicators

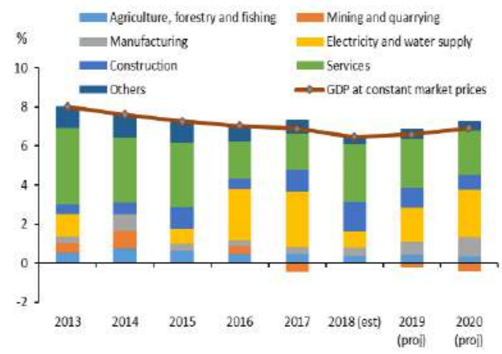
### Figure 1.1. Real Sector

The resource sector (agriculture, mining and hydropower) is the most important, accounting for a third of the economy.



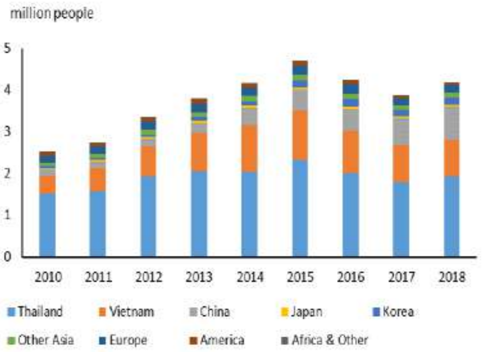

Source: Lao Statistics Bureau, AMRO staff estimates

Growth is expected to recover slightly in 2019 as the impact of the flood dissipates and large hydropower projects commence operations.



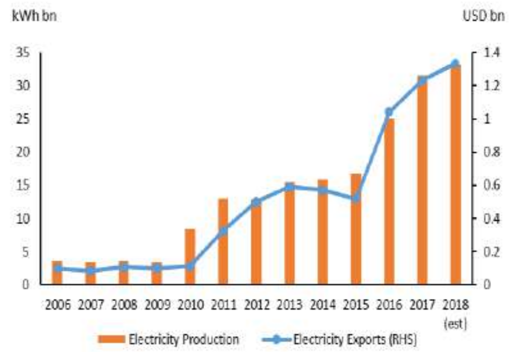

Source: Lao Statistics Bureau, AMRO staff estimates

Tourist arrivals increased for the first time in 2 years, growing by 8.2 percent in 2018.



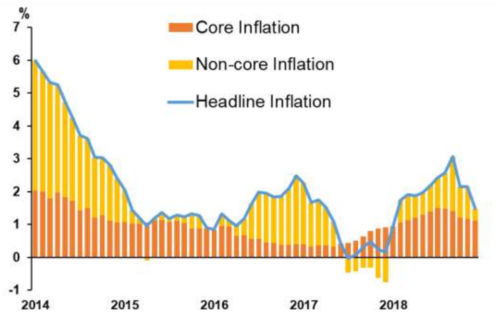

Source: Lao Statistics Bureau, AMRO staff estimates

Electricity production and exports have risen in large intermittent episodes related to massive hydropower projects.



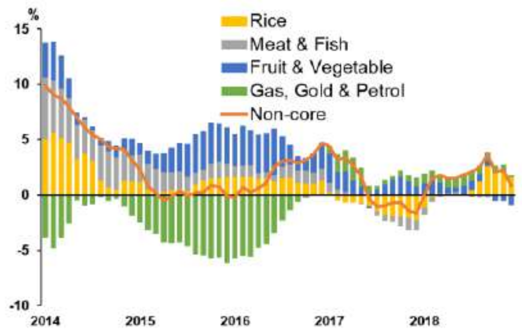

Source: Lao Statistics Bureau

Inflation increased to 2.0 percent in 2018 as the economy experienced some supply constraints due to floods from July-September 2018.




Source: Lao Statistics Bureau, AMRO staff estimates

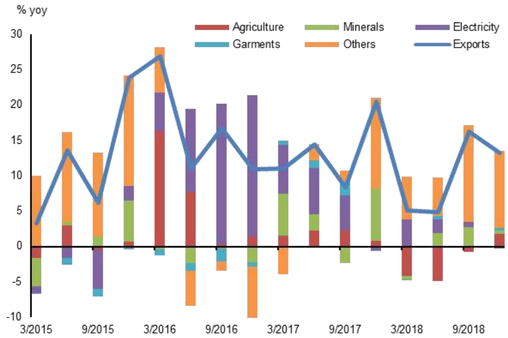
Inflation was mainly driven by rising food and petrol prices.




Source: Lao Statistics Bureau, AMRO staff estimates

## Figure 1.2. External Sector

SEZ-related manufacturing drove exports while agriculture exports contracted.

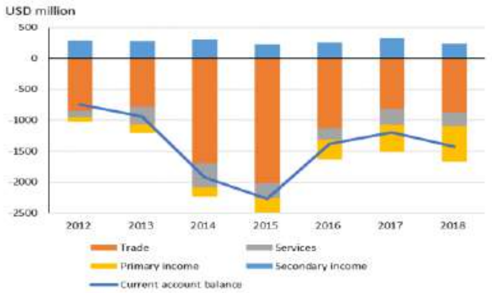



Source: Bank of Lao PDR, AMRO staff estimates

Imports were mainly driven by intermediate and capital goods.


Source: Bank of Lao PDR, AMRO staff estimates

The current account deficit deteriorated in 2018 due to the widening trade deficit and primary income outflows.

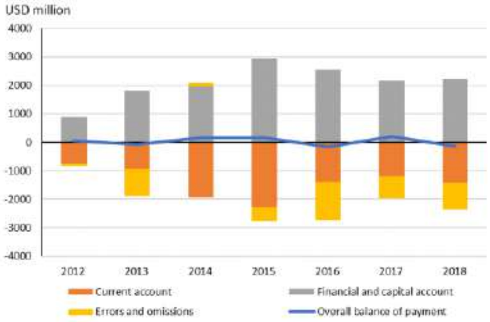



Source: Bank of Lao PDR

Steady inflows of foreign investment and portfolio inflows partially financed the sizeable current account deficit.

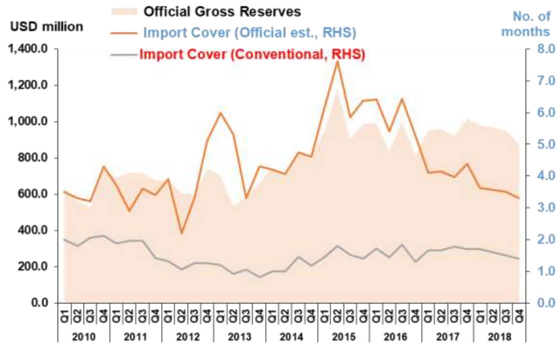

Source: Bank of Lao PDR

The overall BOP registered a small deficit in 2018.




Source: Bank of Lao PDR

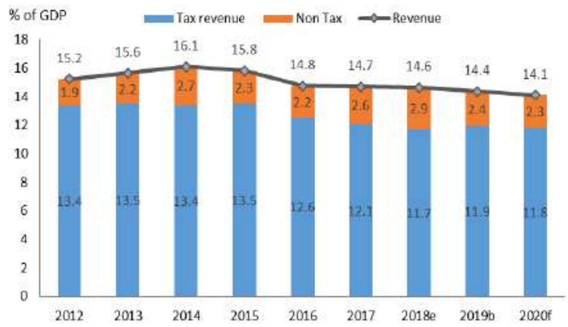
FX reserves went down to USD873 billion at the end of 2018, equivalent to about 1.4 months of imports.




Source: Bank of Lao PDR, AMRO staff estimates

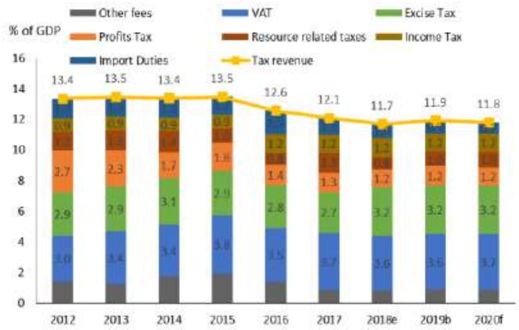
## Figure 1.3. Fiscal Sector

Stronger efforts are needed to raise domestic revenues amid the declining trend of tax and non-tax collection.



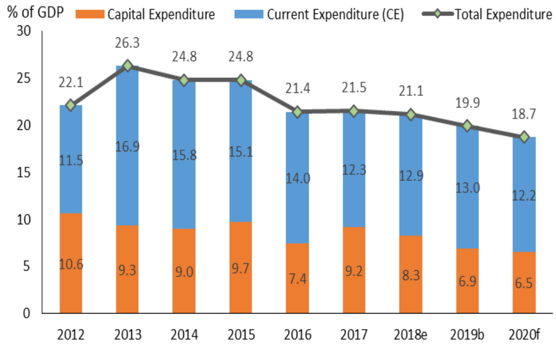

Source: Ministry of Finance, AMRO staff estimates

The tax structure is dominated by consumption taxes such as VAT and excise taxes, accounting for more than half of total tax revenue.



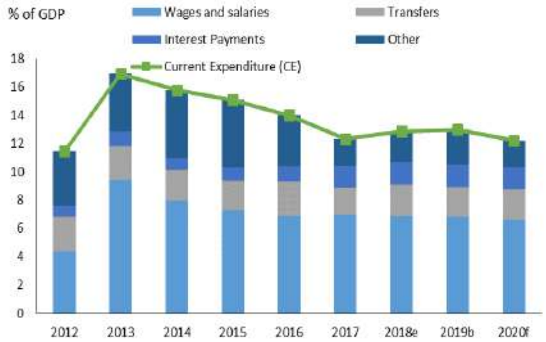

Source: Ministry of Finance, AMRO staff estimates

Efforts to cap current expenditure are needed to enable fiscal space for capital expenditure.



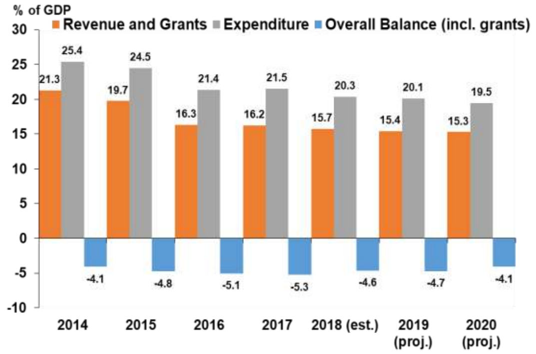

Source: Ministry of Finance, AMRO staff estimates

Tight expenditure management is needed to control current expenditure as wages account for the largest share while interest payments are rising.



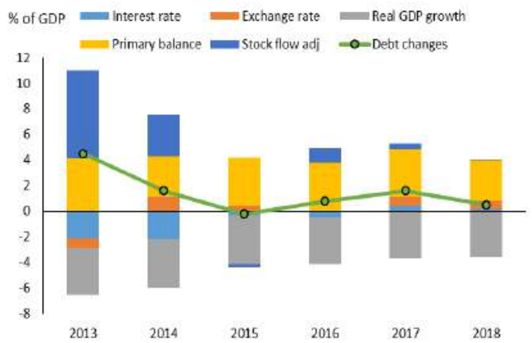

Source: Ministry of Finance, AMRO staff estimates

Fiscal consolidation is expected to be mainly achieved through expenditure rationalization rather than by raising revenues.




Source: Ministry of Finance, AMRO staff estimates

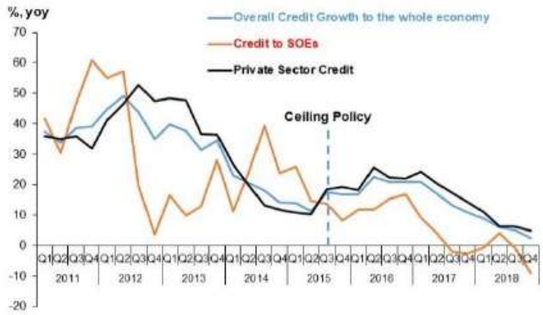
Public and publicly guaranteed debt-to-GDP was pushed upward mainly by primary deficits, while robust GDP growth helped curb the increase.




Source: Ministry of Finance, AMRO staff estimates

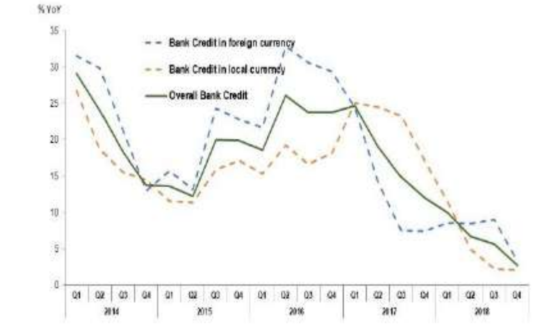
## Figure 1.4. Monetary and Financial Sectors

The moderation in domestic credit growth could be attributed to the contraction of credit to SOEs and lower private sector credit growth.



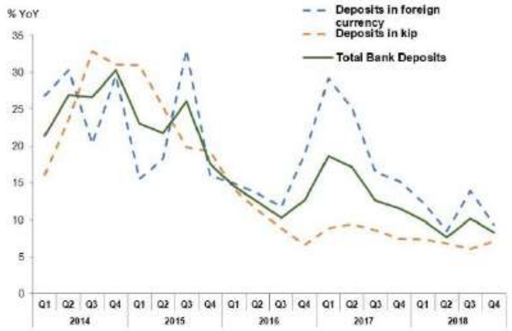

Source: Bank of Lao PDR

Foreign currency lending edged up in the second half of 2017 due to a relaxation in restrictions, but fell in the last quarter of 2018.



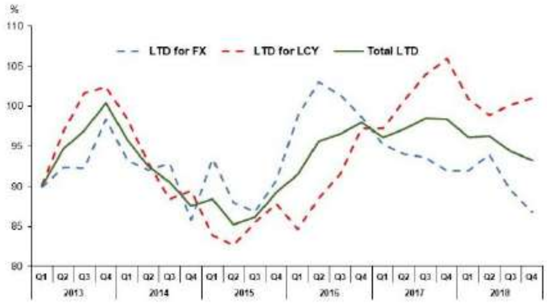

Source: Bank of Lao PDR

Deposit growth in foreign currency has been on a declining trend, while deposit growth in kip has been relatively flat.




Source: Bank of Lao PDR

Weak kip deposit growth has resulted in a rising loan-to-deposit ratio for the kip, even amid a decline in credit growth.

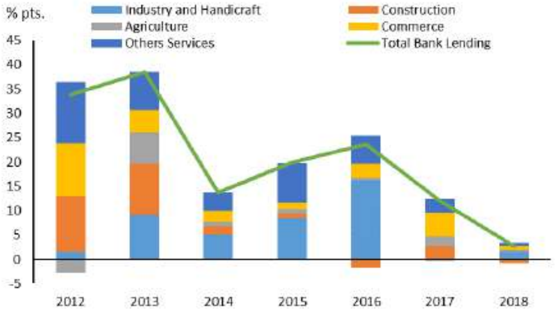



Source: Bank of Lao PDR

External borrowing by banks increased after the implementation of interest rate ceiling policy but has stabilized since 2017.


Source: Bank of Lao PDR

Credit growth to most sectors slowed down.




Source: Bank of Lao PDR

## Appendix 2: Selected Economic Indicators for Lao PDR

| | 2015 | 2016 | 2017 | 2018 (est) | Projections 2019 | Projections 2020 |
|---|---|---|---|---|---|---|
| **Real Sector and Prices** | (In percent change unless specified) | | | | | |
| Real GDP | 7.3 | 7.0 | 6.9 | 6.5 | 6.6 | 6.9 |
| GDP deflator | 2.3 | 3.0 | 1.9 | 1.7 | 2.3 | 2.7 |
| Consumer price inflation (average) | 1.3 | 1.6 | 0.8 | 2.0 | 2.1 | 2.5 |
| Unemployment rate | 1.3 | 1.4 | 1.5 | … | … | … |
| **External Sector** | (In millions of USD unless otherwise specified) | | | | | |
| Export | 3,653 | 4,245 | 4,873 | 5,295 | 5,919 | 6,824 |
| Import | 5,675 | 5,372 | 5,667 | 6,164 | 6,801 | 7,666 |
| Trade balance | -2,022 | -1,128 | -794 | -869 | -883 | -842 |
| In percent of GDP | -14.0 | -7.1 | -4.7 | -4.8 | -4.5 | -3.9 |
| Current account balance | -2,268 | -1,385 | -1,260 | -1,430 | -1,380 | -1,405 |
| In percent of GDP | -15.7 | -8.7 | -7.4 | -7.8 | -7.0 | -6.5 |
| Capital and financial account balance | 2,919 | 2,534 | 2,173 | 2,219 | 2,005 | 2,000 |
| In percent of GDP | 20.2 | 15.9 | 12.7 | 12.1 | 10.2 | 9.3 |
| Overall balance | 171 | -172 | 201 | -143 | 25 | 195 |
| Official gross reserves | 987 | 815 | 1,016 | 873 | 896 | 1,091 |
| In months of imports of goods & services | 1.8 | 1.5 | 1.8 | 1.4 | 1.3 | 1.7 |
| Export volume | -9.4 | 8.4 | 13.6 | 7.0 | 9.2 | 12.4 |
| Import volume | -7.4 | -12.2 | 7.8 | 6.9 | 7.7 | 10.1 |
| External debt, gross | 11,663.8 | 13,523.5 | 14,497.7 | 15,923 | … | … |
| In percent of GDP | 80.8 | 85.0 | 84.9 | 87.4 | … | … |
| | | | | | | |
| **Fiscal Sector (General Government)** | (In percent of GDP) | | | | | |
| Revenue and grants | 20.2 | 16.4 | 16.1 | 15.5 | 15.5 | 15.8 |
| Expenditure | 26.1 | 21.5 | 21.6 | 19.9 | 20.1 | 20.0 |
| Current expenditure | 15.4 | 15.5 | 12.5 | 12.5 | 13.2 | 12.7 |
| Capital expenditure | 10.8 | 6.1 | 9.2 | 7.5 | 6.9 | 7.3 |
| Net lending/borrowing balance | -5.9 | -5.2 | -5.5 | -4.4 | -4.6 | -4.2 |
| Primary net lending/borrowing balance | -4.9 | -3.9 | -4.2 | -2.7 | -2.6 | -2.3 |
| Public and publicly guaranteed debt | 57.7 | 58.8 | 60.1 | 60.8 | 61.3 | 61.2 |
| Of which external | 48.4 | 48.5 | 50.5 | 51.4 | 51.8 | 51.4 |
| **Monetary and Financial Sector** | (In percent per annum, end-period unless specified) | | | | | |
| Domestic credit | 17.9 | 18.5 | 6.4 | 9.2 | 9.8 | 13.9 |
| Private Sector | 19.3 | 22.0 | 14.2 | 4.4 | 10.7 | 15.5 |
| Private Sector credit (% of GDP) | 37.1 | 41.0 | 43.0 | 41.5 | 42.8 | 43.8 |
| Broad money | 14.7 | 10.9 | 12.2 | 8.4 | 12.3 | 14.7 |
| Reserve money | 6.6 | -1.4 | 9.5 | 4.7 | 8.9 | 10.2 |
| **Memorandum Items** | | | | | | |
| Nominal GDP (LAK billion) | 117,251 | 129,280 | 140,749 | 152,375 | 166,175 | 182,444 |
| Nominal GDP (USD million) | 14,430 | 15,913 | 17,070 | 18,224 | 19,562 | 21,461 |
| GDP per capita (USD) | 2,222.8 | 2,409.9 | 2,585.1 | 2,777.7 | 3,011.2 | 3,129.2 |
| Exchange rate (against USD, average) | 8,125 | 8,124.4 | 8,245.6 | 8,361.1 | … | … |

Note: Fiscal sector projections are from AMRO's baseline scenario.
Source: BOL, LMOF, LSB, AMRO staff estimates

## Appendix 3. Balance of Payments

| Indicators | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| | (In millions of U.S. dollars; unless specified) | | | | |
| Current account | -1,924 | -2,268 | -1,385 | -1,260 | -1,430 |
| Trade balance | -1,699 | -2,022 | -1,128 | -794 | -869 |
| Exports, f.o.b. | 3,276 | 3,653 | 4,245 | 4,873 | 5,295 |
| Imports, c.i.f. | 4,976 | 5,675 | 5,372 | 5,667 | 6,164 |
| Services, net | -386 | -234 | -188 | -336 | -233 |
| Primary income, net | -149 | -232 | -325 | -446 | -571 |
| Of which: Interest payments | 99 | 125 | 158 | 210 | 257 |
| Secondary income, net | 310 | 221 | 255 | 317 | 242 |
| Capital and financial account | 1,908 | 2,919 | 2,534 | 2,173 | 2,222 |
| Financial account (net) | 1,908 | 2,919 | 2,534 | 2,173 | 2,222 |
| Direct investment (net) | 861 | 1,038 | 920 | 1,677 | 1,320 |
| Portfolio investment (net) | 367 | 538 | 514 | 326 | 498 |
| Other investment (net) | 681 | 1,343 | 1,100 | 170 | 391 |
| Errors and omissions | 170 | -480 | -1,321 | -712 | -934 |
| Overall balance | 154 | 171 | -172 | 201 | -143 |
| **Memorandum items:** | | | | | |
| Current account (% of GDP) | -14.5 | -15.7 | -8.7 | -7.4 | -7.8 |
| Gross official reserves (in millions of US$) | 816 | 987 | 815 | 1,016 | 873 |
| (In months of imports of goods and services) | 1.6 | 1.8 | 1.5 | 1.8 | 1.4 |
| Nominal GDP (USD million) | 13,279 | 14,430 | 15,913 | 17,070 | 18,224 |
| Exchange rate (against USD, average) | 8,042 | 8,125 | 8,124 | 8,246 | 8,361 |

Source: BOL

## Appendix 4. Statement of Government Operations

| Indicators | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| | (In billions of kip; unless specified) | | | | |
| Revenue and grants | 23,340 | 23,699 | 21,141 | 22,825 | 23,609 |
| Tax revenue | 14,681 | 16,321 | 16,427 | 16,918 | 17,088 |
| VAT | 3,862 | 4,988 | 4,688 | 5,034 | 5,201 |
| Excise | 3,340 | 3,253 | 4,124 | 4,253 | 4,798 |
| Personal income tax | 1,026 | 1,140 | 1,624 | 1,656 | 1,619 |
| Corporate income tax | 1,894 | 2,206 | 1,751 | 1,782 | 2,073 |
| Import duties | 1,409 | 1,382 | 1,655 | 971 | 1,059 |
| Resource taxes | 1,487 | 1,545 | 971 | 1,316 | 1,097 |
| Non-Tax revenue | 2,713 | 2,759 | 2,965 | 3,500 | 5,007 |
| Grants | 5,947 | 4,618 | 1,749 | 2,197 | 1,513 |
| Expenditure | 27,186 | 30,652 | 27,825 | 30,426 | 30,371 |
| Expense | 16,673 | 18,035 | 19,981 | 17,534 | 19,014 |
| Compensation of employees | 8,683 | 8,988 | 9,198 | 9,807 | 10,051 |
| Materials and supplies | 1,781 | 2,938 | 3,005 | 2,757.4 | 2,961.8 |
| Transfers | 2,358 | 2,707 | 3,127 | 2,661.8 | 2,986.1 |
| Interest | 942 | 1,191 | 1,584 | 1,947.4 | 2,646.3 |
| External | 734 | 953 | 1,238 | 1,490.8 | 2,115.0 |
| Domestic | 208 | 238 | 347 | 456.5 | 531.4 |
| Net acquisition of non-financial assets | 10,513 | 12,617 | 7,843 | 12,892 | 11,356.2 |
| Net lending/borrowing balance (incl. Grants) | -3,845 | -6,953 | -6,683.8 | -7,811 | -6,762.1 |

Source: LMOF

## Appendix 5. Monetary Survey

| Indicators | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| | (In billions of kip; unless specified) | | | | |
| Net Foreign Assets | 1803.0 | -3188.4 | -11268.3 | -7,769.3 | -9,248.3 |
| Assets | 16352.9 | 16876.5 | 15580.5 | 18,437.8 | 17,159.2 |
| Liabilities | 14549.9 | 20065.0 | 26848.8 | 26,207.1 | 26,407.5 |
| | | | | | |
| Net Domestic Assets | 50519.3 | 63187.7 | 77807.8 | 82,440.0 | 90178.5 |
| Net Domestic Credit | 50536.1 | 59560.4 | 70572.6 | 75,087.6 | 81984.1 |
| Public sector | 14091.3 | 16084.4 | 17544.7 | 14,548.1 | 18,786.9 |
| Government | 3,654.5 | 4,794.5 | 4,373.2 | 1,722.8 | 6,588.0 |
| SOEs | 10,436.8 | 11,289.9 | 13,171.6 | 12,825.3 | 12,198.9 |
| Private sector | 36,444.8 | 43,476.0 | 53,027.9 | 60,539.4 | 63,197.2 |
| Other items net | -16.7 | 3,627.3 | 7,235.2 | 7,359.9 | 8,194.5 |
| | | | | | |
| Reserve Money | 19,826.2 | 21,130.5 | 20,835.1 | 22,812.4 | 23,872.6 |
| Broad Money | 52322.2 | 59998.9 | 66527.6 | 74678.2 | 80,930.3 |
| Currency in circulation | 6,316.0 | 5,879.7 | 5,534.3 | 6,638.2 | 7,148.9 |
| Deposits | 46006.2 | 54119.2 | 60993.3 | 68,032.5 | 73,672.9 |
| Of which: Foreign currency | 22956.0 | 26633.2 | 31702.4 | 36,553.5 | 39,894.0 |
| Of which: LCY currency | 23050.2 | 27486.0 | 29290.9 | 31,479.0 | 33,778.9 |

Source: BOL

## Appendix 6. Data Adequacy for Surveillance Purposes: a Preliminary Assessment

| Criteria/ Key Indicators for Surveillance | Availability (i) | Reporting Frequency/ Timeliness (ii) | Data Quality (iii) | Consistency (iv) | Others, if Any (v) |
|---|---|---|---|---|---|
| **National Accounts** | - GDP on the production side is the main approach, while the expenditure approach has yet to be made available.<br>- Limited unemployment and labor market data, available mostly from IFIs. | Dissemination of GDP data is on an annual basis with a time lag of six months. | - In 2017, GDP was rebased to 2012 from 2002 using data from the 5th Lao Expenditure and Consumption Survey 2012/13. GDP compilation broadly follows System of National Accounts (SNA) 1993 and has also started to implement parts of SNA 2008.<br>- Data collection techniques remain weak due to resource constraints. | - | Ongoing activities in GDP compilation include methodological and data upgrades to enable release of GDP by expenditure and a new quarterly GDP series. |
| **Balance of Payments (BoP) and External Position** | - Overall Balance of Payments (BoP) data have been published by the Bank of Lao PDR (BOL) and are publicly available on the BOL website.<br>- Time-series data on international reserves and central government external debt are publicly available, while the breakdown into short-term and long-term debt has never been published. | - BoP data has been released on a quarterly basis with a time lag of one quarter.<br>- External trade data has been released on a quarterly basis with a time lag of one quarter. | - A new time series in BPM6 format was published starting 2018. Further improvements in the compilation of merchandise trade, external debt data and the FDI survey is still work-in-progress.<br>- External trade data is incomplete, especially on the import side, as it covers only major items where their values are based on a medium price classification specified by the authorities in the past. | - Trade data is often inconsistent among government agencies.<br>- There is a large discrepancy between trade data from national sources and the IFIs, as well as the major trading partners, in particular for import data.<br>- Large errors and omissions in several periods make the analysis and interpretation of the BoP data difficult (high levels of errors and omissions in different periods were very close to the differences in trade balances between national sources and key trading partners'). | There are ongoing activities to enhance the coverage of exports and imports to narrow the data discrepancies between Customs, BOL and the Ministry of Industry and Commerce (MOIC). |
| **State Budget and Government Debt** | - Budget implementation data are released by the Ministry of Finance<br>- Public debt and contingent government liability statistics are available upon request. | Publication of budget implementation statistics is on a bi-annual basis with a time lag from six months to one year. | The use of Government Finance Statistics (GFS) standards and procedures are weak. The data coverage is limited to the operations of the budget. Off-budget activities are not included in the fiscal data. | - Persistent off-budget expenditure<br>- International practice in implementing the budget plan is limited and largely driven by local practices. | |
| **Inflation, Money Supply and Credit Growth** | - Inflations and Monetary statistics released by the BOL are publicly available on its website.<br>- Data on credit, the breakdown into claims on government, credit to SOEs and credit to the private sector, are available. | - CPI data are released monthly with a time lag one to two months.<br>- Food and non-food CPI data are publicly released with a time lag from two to three months.<br>- Monetary and credit data are publicly released on a quarterly and yearly basis with a time lag of three months. | - In 2016 the CPI was updated to include all 18 provinces (extending the previous coverage of 12 provinces). The number of items was also expanded to 485 from 245 with weights generated from the 2012 Lao Social Indicator Survey (LSIS).<br>- The actual amount of US dollars and other foreign currency-denominated bills circulating in the economy has not been captured in the official monetary statistics. The money supply data includes only deposits in banks (denominated in both local and foreign currencies) and bills in circulation (in local currency only). | | |
| **Financial Sector Soundness Indicators** | - Compiled indicators for the financial soundness indicators (FSI)s are published on the BOL website. | Quarterly and yearly data are available at the BOL's website, usually with a time lag of six months. | FSI indicators are generally compiled based on the IMF FSI Guide. | - | - |
| **State-Owned-Enterprises Statistics** | SOE statistics have yet to be made available on a frequent basis. | - | - | - | - |

Notes:

(i) Data availability refers to whether the official data are available for public access by any means.

(ii) Reporting frequency refers to the periodicity that the available data are published. Timeliness refers to how up-to-date the published data are relatively with the publication date.

(iii) Data quality refers to the accuracy and reliability of the available data given the data methodologies are taken into account.

(iv) Consistency refers to both internal consistency within the data series itself and its horizontal consistency with other data series of either same or different categories.

(v) Other criteria might also apply, if relevant. Examples include but are not limited to potential areas of improvement for data adequacy.

Source: AMRO staff compilations. This preliminary assessment will form the "Supplementary Data Adequacy Assessment" in the EPRD Matrix

## Annexes: Selected Issues

### Annex 1: Financial Sector Development in Lao PDR[42]

1. **Lao PDR's financial sector is essentially bank-based while the capital market remains at an early development stage.** As of 2017, bank claims on the economy were about 52.4 percent of GDP, whereas stock market capitalization and government bonds outstanding stood at about 8 percent and 4 percent respectively[43] (Table A1.1). The banking system has developed from a mono-banking system prior to 1986 to consist of three state-owned commercial banks (SOCBs);[44] three state joint venture banks; 16 privately-owned domestic banks (of which eight are foreign bank subsidiaries); and 19 foreign bank branches. Despite rapid growth in recent years, non-bank financial institutions remain modest with total assets of less than 1 percent of GDP in 2018[45]. The capital market has been developed more recently, with the launch of the Lao Stock Exchange (LSX) in 2011 and a specialized government bond trading platform enacted at the LSX in late 2018. Financial, regulatory and supervisory responsibilities have been shared between the Bank of Lao PDR (BOL) and the Ministry of Finance (MOF). The BOL is in charge of regulating banks and non-bank financial institutions, as well as supervising the stock market, while the MOF is responsible for the bond market and insurance sector. The National Social Security Fund (NSSF), meanwhile, is under the supervision of the Ministry of Labor and Social Welfare, with representatives from the MOF participating in the Fund's Committee.

**Table A1.1. Financial Sector Development Indicators**

| in percent of GDP | 1995 | 2000 | 2005 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Bank assets** | - | - | 21.1 | 45.0 | 50.4 | 62.3 | 66.3 | 76.0 | 83.3 | 87.5 | 87.5 |
| **Bank claims on the economy** | 5.5 | 13.2 | 8.9 | 26.2 | 31.4 | 37.4 | 43.7 | 43.9 | 46.7 | 51.2 | 52.4 |
| o/w: bank claims on the private sector | - | 8.9 | 6.6 | 19.9 | 22.6 | 29.3 | 34.8 | 34.1 | 37.1 | 41.0 | 43.3 |
| o/w: bank claims on SOEs | - | 4.3 | 2.3 | 6.4 | 8.8 | 8.1 | 9.0 | 9.8 | 9.6 | 10.2 | 9.2 |
| **Stock market capitalization** | - | - | - | - | 6.4 | 10.0 | 9.4 | 10.3 | 10.3 | 8.1 | 8.1 |
| **Government bonds outstanding** | - | - | - | 1.7 | 1.2 | 2.9 | 2.5 | 5.1 | 5.6 | 5.7 | 3.9 |

Note: Bond data refer to domestic government bonds outstanding held by commercial banks only.
Source: BOL; LSX; Nomura Research Institute (NRI); CEIC; AMRO staff calculations

2. **The financial liberalization wave has brought about a relatively rapid expansion in the banking sector over the past two decades.** In particular, following the issuance of the first Commercial Bank Law in 2006 (Box A1.1 on Banking Sector Regulatory Framework Developments: 1986-2018), 30 more banks and foreign branches were licensed, bringing the total number of commercial banks and foreign branches from 11 prior to 2006 to 41 in 2017 (Table A1.2). Total bank assets increased four-fold during the same period, standing at 87.5 percent of GDP in 2017. This has led to a lower SOCB share from 60 percent of total bank assets prior to 2006, to slightly above

[42] Prepared by Nguyen Thi Kim Cuc and Malichanh Chiemsisoulath
[43] This refers to government bonds issued in the domestic currency, Lao kip, held by commercial banks only. Data is sourced from the Nomura Research Institute. The Government of Lao PDR, meanwhile, has issued sovereign bonds denominated mainly in Thai baht in the Thai bond market since 2013, with a total bonds outstanding equivalent to USD1,651 million or 9.1 percent of GDP, as of end-2018, which will be due between 2019-2032.
[44] The three SOCBs are the Banque pour le Commerce Exterieur Lao Public (BCEL), Lao Development Bank (LDB) and Agriculture Promotion Bank (APB).
[45] Non-bank financial institutions comprise 97 microfinance institutions (MFIs), 27 savings and credit unions (SCUs), 27 pawn shops, 29 leasing countries, and five money transfer agencies.

40 percent in 2018. Foreign bank branches' market share has increased significantly with the establishment of the Industrial and Commercial Bank of China (ICBC) branch in Vientiane in 2012. They now account for 29 percent of total bank assets in 2018, up from about 16 percent prior to 2006. The remainder, constituting joint venture banks, foreign bank subsidiaries and private local banks, accounted for about 28 percent of total bank assets in 2018. Notwithstanding the increase in number of banks, bank assets remain concentrated to a significant extent among the two largest banks, namely the Banque pour Commerce Exterieur Lao Public (BCEL) and ICBC Vientiane Branch, resulting in a wide gap between these two banks and the others.

**Box A1.1. Banking Sector Regulatory Framework Developments: 1986-2018**

| | |
|---|---|
| 1986 | Lao PDR started to transform its economy from a central planned economy to a market-oriented economy under the "New Economic Mechanism".[46] |
| 1988 | The Banking System was transformed from a mono-banking system[47] into a two-tier banking system (Resolution No. 2/PSL). Nineteen branches of the State Bank were transformed into seven SOCBs by 1991.[48] |
| 1990 | The Central Bank Law was amended, establishing the Bank of the Lao PDR (BOL) to replace the State Bank.[49] |
| 1992 | The Prime Minister issued a Decree on the management of commercial banks and other financial institutions (No.3/PM). |
| 1993 | PM Decree on the Organisation and Activity of the Bank of the Lao PDR No. 95/PM issued. |
| 1995 | BOL Law amended to replace the Central Bank Law (No. 05/95/NA). |
| 1996 | Six prudential regulations for commercial banks and Agricultural Promotion Bank issued by BOL.<br>New Chart of Accounts introduced for commercial banks. |
| 1997 | PM Decree No. 3/PM was upgraded to Presidential Decree on Commercial Banks (No.01/PR). By this upgrading, they restructured the SOCBs from seven to three SOCBs.[50] |
| 1998 | New regulations on asset classification and loan loss provisions promulgated.<br>Program of consolidation, incorporation and recapitalization of SOCBs launched. |
| 1999 | Law on the Bank of the Lao PDR was amended to enhance the effectiveness of banking management and supervision. |
| 2000 | The Presidential Decree on Commercial Banks was amended, restructuring SOCBs by merging Lane Xang Bank and Lao Mai Bank to be the Lao Development Bank (No.02/PR). |
| 2001 | Provision on the Capital Adequacy of Commercial Bank was issued (No. 01/BOL). |
| 2006 | The Law on Commercial Banks was introduced to replace the Presidential Decree on Commercial Banks (No.3/NA) which determined the minimum capital investment of Domestic Commercial Bank to LAK100 billion, and the minimum capital investment of foreign bank branches to LAK50 billion. |
| 2009 | Decree on the implementation of Commercial Bank Law was issued (No. 275/PM). |
| 2009 | Prime Ministerial Agreement on the increase of minimum capital investment of Domestic Commercial Banks from LAK100 billion to LAK300 billion and minimum capital investment of Foreign Bank Branches from LAK50 billion to LAK100 billion (No. 141/PM). |
| 2011 | Provision on asset classification and loan loss provisions (No. 324/BOL) and its operational guideline was introduced (No. 541/BSD). |
| 2016 | 10-Year Strategic Plan for Financial System Development of the Lao PDR (2016-2025) and Vision towards 2030 was launched to replace the 10-Year Strategic Plan (2009-2020). |
| 2017 | Implementation plan of BASEL II for 2017-2025 was established. |
| 2018 | Provision on asset classification and loan loss provisions (No. 512/BOL) was revised and replaced provision No. 324/BOL. |

[46] New Economic Mechanism is the major economic reform launched in the Lao PDR in 1986 to turn from the centrally planned economic management system into the market-oriented system. The primary political objectives included 1) open market policies; and 2) introduction of market economic principles.

[47] In a mono-banking system, there is no separation between the central bank and commercial banks. The central bank regulates banking and FX operations which are conducted by its own functional departments.

[48] The 7 SOCBs established in 1989-1991 were Capital Bank, Setthathirath Bank, BCEL, Southern Bank, Lao Mai Bank, Lane Xang Bank and Alounmai Bank. The Agriculture Promotion Bank (APB) was established in 1993.

[49] According to this law, the Central Bank assumes the additional responsibility of regulating and supervising commercial and regional banks.

[50] The Capital Bank and Southern Bank were merged into the Lao Mai Bank; Setthathirath Bank and Alounmai Bank were merged into the Lane Xang Bank**;** while BCEL remained the same.

| | |
|---|---|
| 2018 | Law of the Bank of the Lao PDR was amended.<br>Law on Commercial Banks was also amended, raising the minimum capital investment of domestic commercial banks from LAK300 billion to LAK500 billion and for foreign bank branches from LAK100 billion to LAK300 billion. Banks are also required to set up a risk management system to comply with the BASEL II implementation plan. |

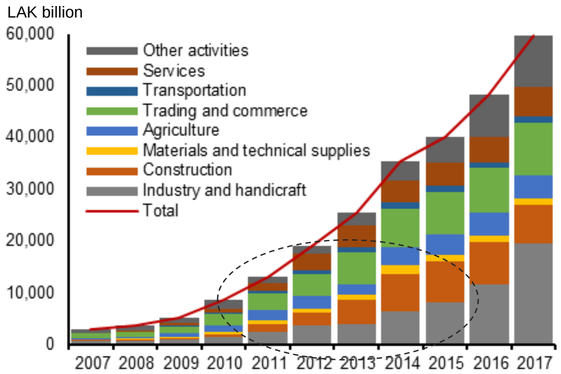
**Table A1.2. Overview of the Banking Sector and a Snapshot in 2018**

| Indicators | No. of newly registered banks | | | | As of 2018 | | | | | | Loan to Deposit (LTD), % |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Total assets | | Total loans | | Total deposits | | |
| | 1985-1995 | 1996-2006 | 2007-2017 | Total | LAK million | % of total | LAK million | % of total | LAK million | % of total | |
| SOCBs | 2 | 1 | - | 3 | 55,987,250 | 42.8 | 33,954,480 | 49.0 | 40,633,820 | 55.2 | 83.6 |
| Joint state banks | - | 1 | 2 | 3 | 12,409,050 | 9.5 | 8,576,390 | 12.4 | 6,047,380 | 8.2 | 141.8 |
| Private, domestic banks | 1 | - | 15 | 16 | 24,508,850 | 18.7 | 14,409,500 | 20.8 | 15,640,820 | 21.2 | 92.1 |
| Foreign bank branches | 6 | - | 13 | 19 | 37,926,920 | 29.0 | 12,293,130 | 17.8 | 11,349,620 | 15.4 | 108.3 |
| Total | 9 | 2 | 30 | 41 | 130,832,070 | 100 | 69,233,500 | 100 | 73,671,640 | 100 | 94.0 |

Source: BOL; AMRO staff calculations

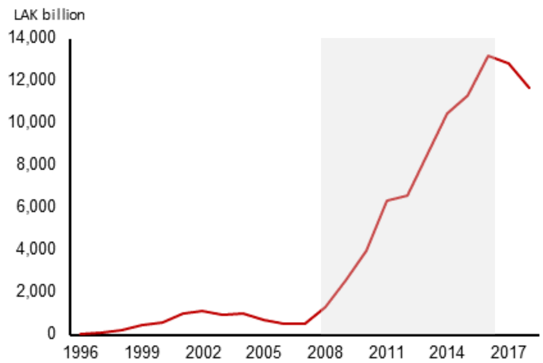
3. **The rapid expansion of the banking sector in recent years is associated with a state-led infrastructure construction boom and a hydropower development drive.** Bank loans to the construction and transportation sectors increased significantly between 2008 and 2013 (Figure A1.1), partly driven by an increase in infrastructure development projects contracted by local governments at different levels, some of which were not authorized by the central government. Foreign bank subsidiaries and branches, mainly from Thailand, China and Vietnam, have increasingly established their presence in Lao PDR, to support the growing number of export-oriented hydropower projects.[51] Domestic banks also participated in the process by helping finance state enterprises in the energy (hydropower) sector in developing domestic projects and transmission networks. Bank exposure to state enterprises increased significantly between 2008 and 2016, and remained elevated at about LAK12 billion, equivalent to about 8 percent of GDP, in 2018 (Figure A1.2).[52]

**Figure A1.1. Commercial Bank Loans by Sector**




Source: BOL; CEIC

**Figure A1.2. Bank Claims on State Enterprises**



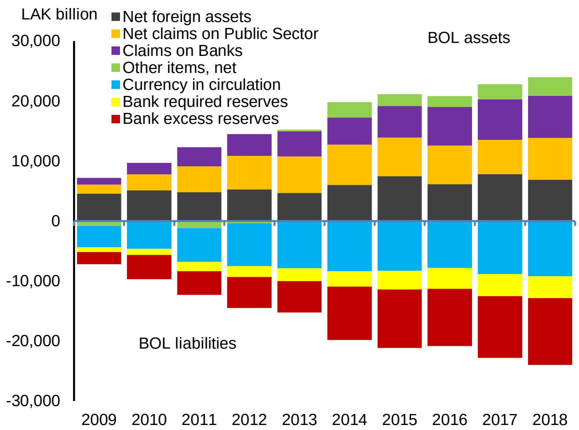

Source: BOL; CEIC

4. **Elevated exposure to state-led infrastructure projects has rendered bank assets vulnerable to unfavorable fiscal developments.** In particular, a worsening fiscal position,[53] driven by dwindling mining- and timber-related revenues and sustained increases in current expenditure after 2012, have led to delays in government payments to private contractors for completed

[51] These independent power producers (IPPs) seek to transform the country into a leading regional energy source.
[52] This accounts for almost 20 percent of total loans outstanding.
[53] The overall budget deficit widened from an average of 2.2 percent of GDP between 2010-2012, to 4.9 percent between 2013-2017.

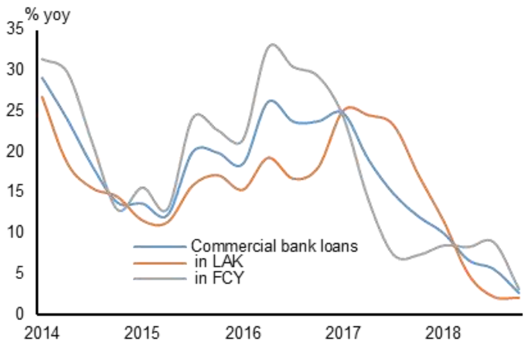
infrastructure projects.[54] This, in turn, translated into rising problem loans at banks. The official NPL ratio, having increased steadily from 1.5 percent of total loans outstanding to 3 percent in 2015, stood at 3.1 percent in 2018. Notably, most overdue loans by unpaid contractors are still classified in banks' balance sheets as "special mention" – which stood at 2.1 percent of total loans, as of Q3 2018. On a positive note, efforts to clear part of such debt arrears have been made with the MOF reportedly issuing government bonds[55] worth LAK3,200 billion (equivalent to about 2.1 percent of GDP) to banks in 2018. The need to focus on the resolution of elevated problem assets contributed in part to a lower risk appetite among banks towards lending, reflected by a significant rise in bank excess reserves at the BOL (Figure A1.3), and a slowdown in credit growth in recent years (Figure A1.4).

**Figure A1.3. Bank of the Lao PDR Balance Sheet and Excess Reserves**




Source: BOL; CEIC

**Figure A1.4. Commercial Bank Loans by Currency**




Source: BOL; CEIC

5. **Lao PDR's stock market remains at an early development stage, underpinned by limited supply, whereas demand was also constrained by a narrow investor base.** In the Lao Stock Exchange (LSX), the number of listed companies increased from two in 2011 to nine in 2018. Stock market capitalization stood at LAK11,374 billion, equivalent to about 8 percent of GDP in 2017, up slightly from 6.4 percent in 2011. Daily trading volume has been generally subdued (Figure A1.5), and led mainly by foreign investors, although this segment holds less accounts than domestic investors.[56] Transactions by domestic retail investors have been muted, while institutional investors – mainly commercial banks – constrained by their own asset problems, have also become less active. Long-term institutional investors such as insurance firms and pension funds are largely absent in the market.

6. **The domestic government bond market is of modest size and fragmented.** Total government bonds outstanding averaged about 5 percent of GDP in 2014-2017 (Figure A1.6), and most of them have short-term maturities of up to five years. Lao PDR's government bonds are held mostly by commercial banks, while long-term investors, such as the NSSF and insurance companies, have accounted for an insignificant share. Prior to 2018, the MOF issued treasury bills and bonds

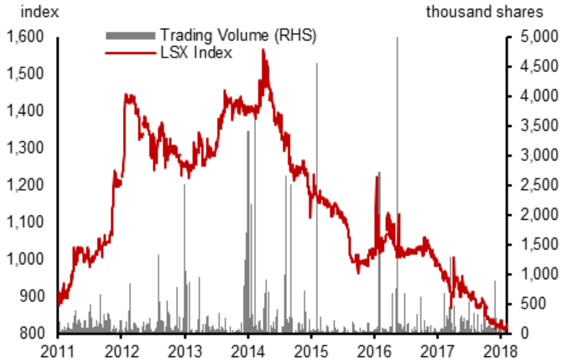
[54] According to the Vientiane Times dated 12 September 2017, out of more than 2,600 completed projects worth LAK22,460 billion as of 2017, only LAK10,050 billion was allocated in the government budget for repayments, leaving an amount of LAK12,400 billion – equivalent to about 8.9 percent of GDP in 2017, still unsettled.

[55] SOCBs, namely BCEL and LDB, are reportedly the main recipients of such debt arrear clearance bond issuance. According to BCEL's financial statement for the first nine months of 2018, bonds would mature from 1 to 10 years, and bear coupons of 3-5 percent for those maturing within a year, 3-5.5 percent for those maturing between 1-5 years, and 4-4.8 percent for those maturing over 5 years.

[56] Foreign investors are mainly from Thailand and China, ordering their trading/ transactions via securities firms. Foreign investors currently hold about 20.5 percent of total accounts – 20 percent is held by foreign retail investors and 0.5 percent by institutional investors. The share of foreign investors in total trading value has, meanwhile, always been greater than 50 percent.

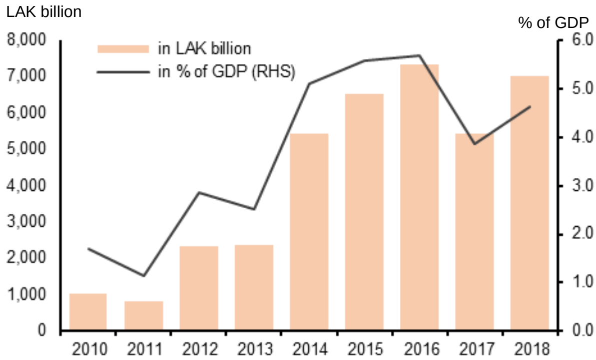
mainly through BOL, adopting volume-based auctions with defined coupon rates. In addition, the MOF issued recapitalization bonds and debt arrear clearance bonds – also known as triangle bonds – via direct offering to banks. Since 2018, debut issuance of government bonds worth LAK285 billion,[57] out of a planned amount of LAK1,000 billion, was conducted via the LSX platform,[58] with commercial banks being the sole buyer.[59] Unattractive bond coupon rates, short-term bond maturities and an irregular issuing schedule with a limited time frame are cited by potential (long-term) investors as the main deterrents in participating in the government bond market. Finally, the current practice that BOL accepts only government bonds with maturities of one year and below as required reserves,[60] has not incentivized banks to hold papers of longer tenors.

**Figure A1.5. Lao Stock Exchange Index (LSX) and Trading Volume**




Source: LSX; Thomson Reuters Datastream

**Figure A1.6. LAK-denominated Government Bonds Outstanding Held by Commercial Banks**




Note: Data for 2018 are as of Q1 only.
Source: Nomura Research Institute

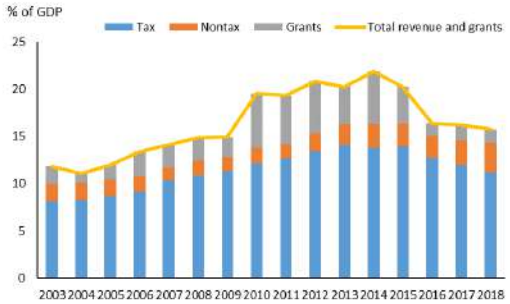
7. **Going forward, improving banking sector soundness and developing the capital markets should be priorities.** As far as banking soundness is concerned, a rapid resolution of outstanding debt arrears is recommended. On a positive note, the 2006 Commercial Bank Law has been recently amended to focus on strengthening bank capitalization and risk management, and the BOL has also adopted a Basel II implementation plan between 2017 and 2025. Further efforts to strengthen banking regulation and supervision are strongly encouraged. The government has launched a Capital Market Development Strategy for 2016-2025 and Vision 2030. In addition, a policy of state enterprise privatization together with mandatory listing requirements could provide a boost to the current limited supply of products in the stock market. The prioritization of developing a domestic bond market is commendable, given Lao PDR's currently high external debt level, which has made it vulnerable to rollover and other FX-related risks. The fine tuning of future government bond issuances, in particular, the offering of market-based bond yields, is necessary to stimulate demand among potential investors. Finally, a credible fiscal consolidation plan that supports debt sustainability will help boost market confidence and broaden the bond investor base to include long-term investors such as the NSSF and insurance firms.

[57] Bond issuance breakdowns are as follows: LAK189 billion were 1-year bonds bearing a coupon rate of 5.3-percent coupon rate, LAK60 billion were 3-year bonds bearing a coupon rate of 6.8 percent, LAK36 billion are 5-year bonds bearing a coupon rate of 6.95 percent. No 7-year bonds were issued, despite a set coupon rate of 7.1 percent.
[58] The remaining amount of LAK715 billion has been planned to be issued in March-April 2019
[59] The interest rate cap policy that imposed an interest ceiling on LAK deposits, effective between 2015 and 2018, allegedly resulted in higher concentration of kip liquidity in some state-owned commercial banks and a shortage among the rest, explaining why those banks were the sole buyer of government bonds issued via the LSX in 2018. The interest rate cap policy was removed in early 2019.
[60] For up to 80 percent of total requirement amount.

## Annex 2: Fiscal Revenues in Lao PDR: Trends and Future Options for Reform[61]

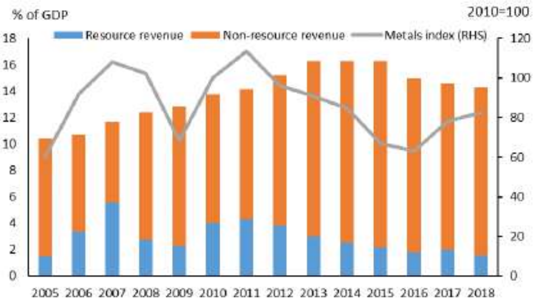
1. **Tax policy reform and large mining operations supported the increase in revenues in the past.** Government revenues expanded from 9.9 percent of GDP[62] in 2003 to an average of 16.3 percent of GDP from 2013 to 2015 (Figure A2.1). This upward trend in revenues in terms of GDP was due to a combination of tax reform measures, improvements in tax administration, and increased proceeds from the resource sector, particularly from mining as the Corporate Income Tax (CIT) allowed the government to benefit from higher commodity prices during that time. A breakdown of the sources of revenues shows that, after growing from 2009 to 2011, a steady decline is observed in resource revenues since 2012. While this decline was initially compensated by increasing non-resource revenues, this trend would later be reversed as non-resource revenue also started to fall in 2016 (Figure A2.2). Grants have also fallen significantly, from above 5 percent of GDP in the past to 1.4 percent of GDP in 2018.

**Figure A2.1. Total Revenue and Grants**




Source: Ministry of Finance (MOF)

**Figure A2.2. Resource and Non-Resource Revenues**



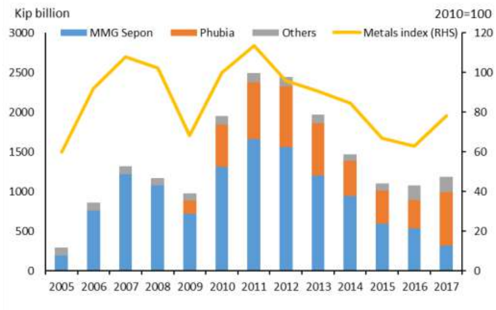

Source: MOF, Ministry of Mines (MOM), World Bank

2. **Resource revenues are mainly derived from the mining and hydropower sectors.** The increase in the production of copper and gold together with high commodity prices helped boost fiscal revenues from the mining sector during the years 2005 to 2011, peaking at 3.46 percent of GDP in 2011 (Figure A2.3). With the subsequent decline in mining revenues, due in part to the decline in commodity prices, Lao PDR can be considered as having undergone the full resource-related boom and bust cycle, with revenues from mining expected to continue to decline going forward, as existing mining operations wind down. Meanwhile, the contribution of hydropower projects to government revenues has remained below 1 percent of GDP as the projects enjoy long concession periods and reduced taxable profits due to hefty debt service payments (Figure A2.4). Nonetheless, revenues from the hydropower sector are projected to gradually rise as several large hydropower plants start operations in 2019 and 2020, with the government poised to benefit from royalties and dividends since it has equity stakes in most of the key projects. The revenues from the existing hydropower projects are expected to increase from mid-2020s with scheduled increases in tax and royalty rates according to the concession agreements, and in 2029 when the first concession expires and the hydropower plant is turned over to the government.

[61] Prepared by Paolo Hernando and Phanomphone Keovongvichith

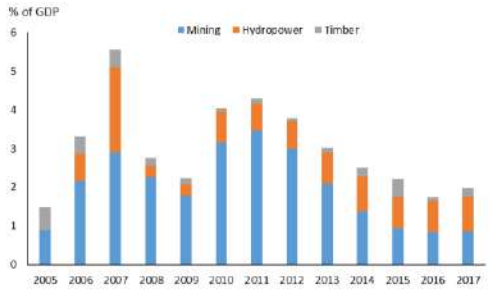
[62] Trends in tax revenues are described in terms of GDP as it is in most cases directly related to economic activity, such that the ratio should remain relatively stable, unless there are policy changes or external factors such as a fall in global commodity prices.

**Figure A2.3. Mining Revenues**




Source: MOM

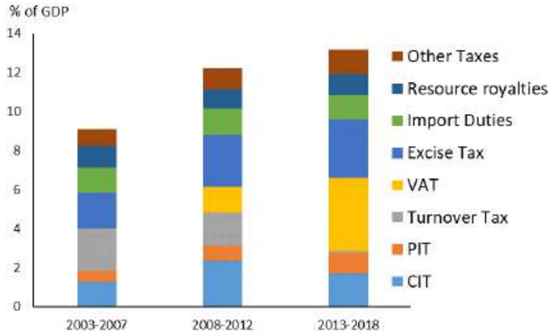
**Figure A2.4. Resource Revenues**




Source: MOF, MOM

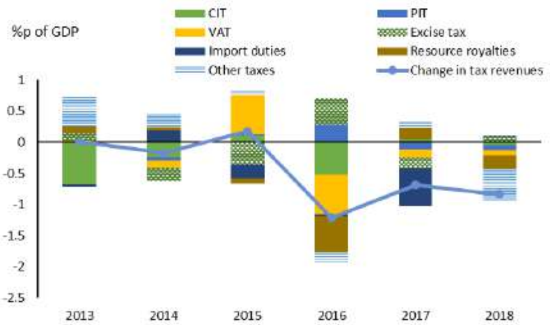
3. **In addition to resource revenues, tax reform initiatives have also helped boost revenue.** The implementation of broad based tax reforms including the introduction of modern tax systems and improvements in administration has enabled tax revenues to steadily rise from an average of 9.1 percent of GDP for the period 2003-2007 to an average of 13.2 percent of GDP for 2013-2018. The introduction of the value-added tax (VAT) in 2010, to gradually phase out the turnover tax, formed part of the key tax reforms. Following the full shift to the VAT system in 2016, the VAT has become the biggest contributor to tax revenues, accounting for around 28 percent of total tax revenue. Excise tax is the second largest contributor at around 20-23 percent of total tax revenues for the past 15 years. In terms of GDP, the collection of VAT and excise tax averaged to 3.7 percent and 3.0 percent of GDP, respectively, for the period 2013-2018 (Figure A2.5).

**Figure A2.5. Drivers of Tax Revenue**




Source: MOF

**Figure A2.6. Changes in Tax Revenue**




Source: MOF, AMRO staff computation

4. **Despite past successes in raising tax revenue, tax collection growth has been slowing in recent years due to a combination of factors.** Since 2016 the major sources of tax revenues have experienced declines, falling cumulatively by 2.7 percentage points of GDP in the last three years. The fall in VAT collection by 0.84 percentage point of GDP accounts for almost a third of the decline in tax revenue from 2016 to 2018 and is mainly attributed to improvements in the VAT refund process, while the fall in import duties by 0.63 percentage point of GDP is due to the country's compliance with various trade agreements. Meanwhile, the combined impact of the fall in corporate income tax (by 0.5 percentage points of GDP) and resource royalties (by 0.6 percentage points of GDP) account for 40 percent of the decline in the past 3 years, mainly due to the slowdown in the

mining sector (Figure A2.6). The fall in VAT collection is expected to be transitory, as the refund system supports the expansion of the VAT base in the future. However, the fall in import duties and mining revenues is expected to be permanent, requiring government to generate new sources of revenue.

5. **Weaknesses in tax administration and burdensome procedures may have also dampened tax collection**. According to tax payment indicators, particularly those related to direct taxes such as payment for corporate income tax and personal income tax, the process in Laos is reportedly relatively cumbersome, taking more time and requiring more steps compared to the regional average (Table A2.1).

**Table A2.1. Tax payment related indicators**

| | Lao PDR | East Asia & Pacific | South Asia | OECD high-income countries |
|---|---|---|---|---|
| Tax payments (number per year) | 35 | 21.2 | 27.6 | 11.2 |
| Time (hours per year) | 362 | 180.9 | 274.8 | 159.4 |
| Total tax and contribution (% of profit) | 24.1 | 33.5 | 43.5 | 39.8 |
| Post-filing index (0-100) | 18.57 | 56.4 | 41.8 | 84.4 |

Note: Post-filing index measures the ease and efficiency of claiming VAT refunds and correcting a corporate income tax return.
Source: World Bank.

6. **Expanding revenue sources and strong administrative efforts are critical to mitigate the decline in revenues.** Given that the decline in mining revenue cannot be fully compensated by rising revenues from the hydropower sector in the near future, policy focus needs to be on developing other sources of revenues. Furthermore, with the decline in development assistance and volatile nature of resource revenues, revenues from the non-resource sector need to fill the gap as a stable source of government revenue to fund priority programs for long-term development. To achieve this, institutional efforts to strengthen tax administration and simplify procedures to minimize administrative burden on the taxpayer need to be continued in order to maximize the revenue potential. Amid the reform efforts, a binding constraint can be administrative capacity, possibly requiring authorities to focus resources on high impact areas such as large corporations and high-income individuals. In addition, the combination of the use of information technology and increased cooperation with banks to collect taxes proved a huge success[63] in improving compliance and reducing leakages. Such efforts should continue and be expanded.

7. **Narrow tax base presents the fundamental structural constraint that could limit the results of the revenue reform efforts.** Authorities' efforts to increase tax revenue are constrained by several structural constraints that can influence how much the reforms could raise revenues in a sustainable manner. For example, the widespread use of tax incentives plays an important role in attracting FDIs into Lao PDR, but significantly limits the government's ability to raise more revenues

[63] To enhance tax administration, a tax information system was launched in Lao PDR on November 2018, facilitating taxpayers' registration, declaration and tax payments. Payments through mobile apps and through banks significantly eased the process and led to a large increase in the road tax collection.

as a percent of GDP. In particular, important drivers of economic growth such as the hydropower projects and companies in SEZs tend to enjoy generous and lengthy tax incentives. Another fundamental difficulty is the lack of accurate tax base information, since a lot of economic activity are outside the tax net, or in hard-to-tax sectors like agriculture and numerous small and micro enterprises that do not have proper accounting procedures in place.

8. **Enhancing the management of tax incentives can help minimize revenue leakages.** With the rapid increase of tax incentives, a comprehensive framework needs to be developed to effectively manage tax expenditures by collecting data on tax incentives and assessing their effectiveness. Going forward, such a system could support the related decision making process and help streamline the incentives in line with national priorities. In particular, the continuation of incentives should be carefully assessed whether companies are delivering on their promises (for example, transfer of knowledge, skills and technology as well as capital investments), and the government needs to evaluate whether the benefits of providing tax incentives outweigh its costs.

9. **Revenue reforms need to be carefully crafted to minimize negative impact on other policy initiatives and reflect taxpayers' capacity.** Raising revenues remains one of the policy priorities of the government, but the government also needs to carefully consider the impact of tax reforms on other key policy initiatives such as poverty reduction, the promotion of micro, small and medium-sized enterprises (MSMEs) and attracting FDIs. In addition, tax reforms need to consider the capacity of taxpayers to raise revenues in a sustainable manner. Increasing revenue collection from a narrow tax base will eventually result in a rising tax burden on the taxable sector. Therefore, well calibrated countervailing measures will be helpful to mitigate increasing tax burden on those affected, but eventually broadening the tax base remains the highest priority.