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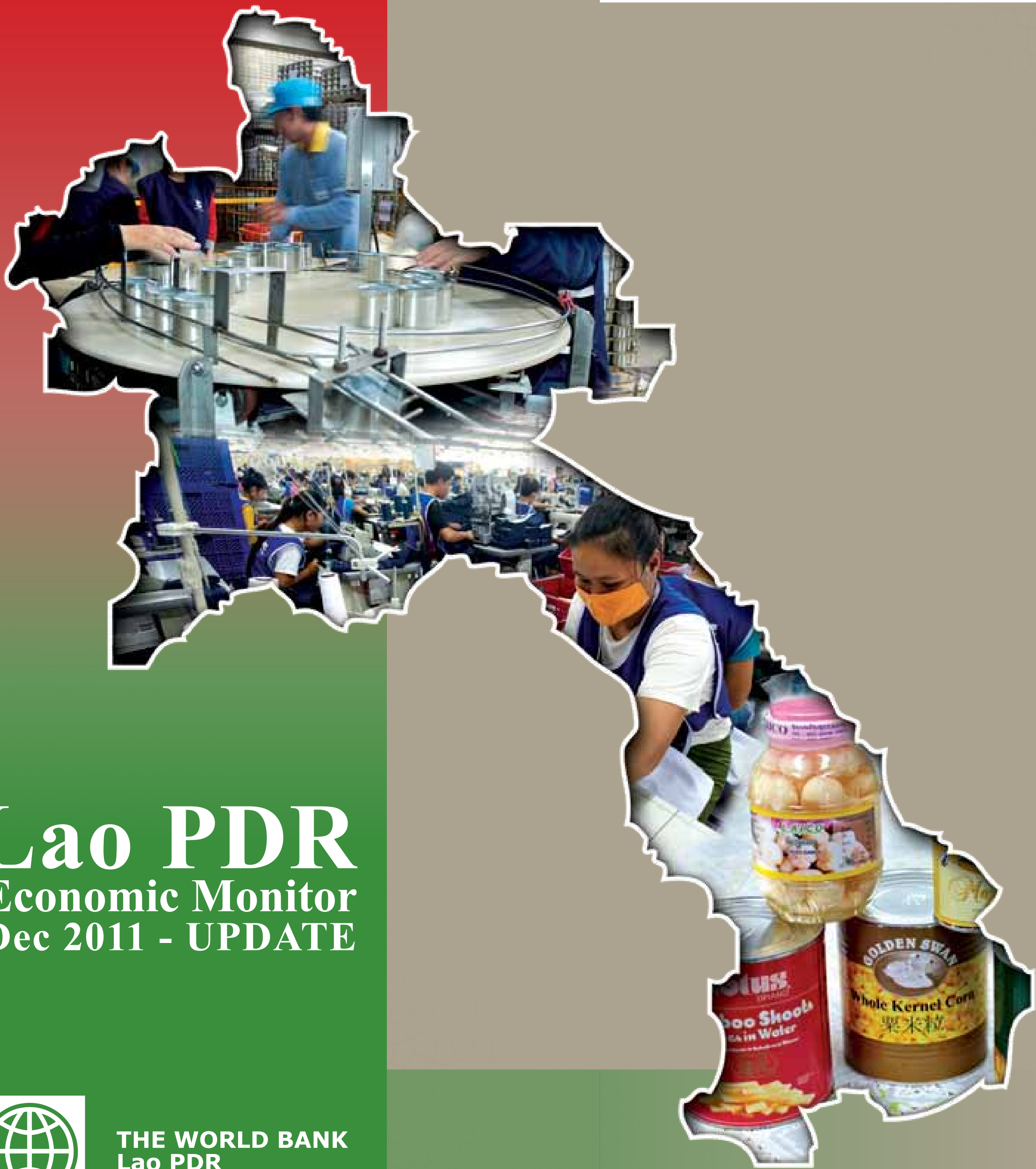
SUSTAINING GROWTH COPING WITH RISING UNCERTAINTY



Lao PDR

Economic Monitor
Dec 2011 - UPDATE

THE WORLD BANK
Lao PDR

The World Bank

Lao PDR Economic Monitor - DECEMBER 2011 UPDATE is issued in Lao and English by the World Bank Office in Lao PDR. This update reports on recent economic developments and medium-term outlook for the country. The paper was prepared by the World Bank Office's macroeconomic policy team consisting of Somneuk Davading (Senior Economist - Task Team Leader), Keomanivone Phimmahasay (Research Analyst) and Genevieve Boyreau (Senior Country Economist - reviewer) under the overall supervision of Mathew Verghis (Lead Economist for South-East Asia Region). We are grateful to the Government (especially BOL, MOF, MPI/LSB, MEM, MOIC, LNTA, MAF and other ministries), LNCCI (including key business associations) and other organizations for providing inputs. We would like to thank our World Bank colleagues: Chanhsom Manythong, Konesawang Nghardsaysone, Meriem Gray, Souridahak Sakonhninhom, Alounsavath Davong, Remy Rossi (consultant), Vattana Singharaj, Boualamphan Phouthavisouk, and other staff for inputs, design, printing and dissemination of the Monitor.

"THE WORLD BANK TEAM APPRECIATES FEEDBACK ON STRUCTURE AND CONTENT OF THE MONITOR"

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Executive Summary

The Lao PDR economy continues to grow vigorously at 8 percent this year despite the impact of typhoons and slower growth in the global economy. That being said, the country's growth estimate was revised slightly downwards to 8 percent from an early estimate of 8.6 percent to account for (i) the adverse impact on agriculture by the typhoons Haima and Nock Ten during the second half of the year as well as the adverse impact of the current flooding in Thailand on Lao PDR's tourism and trade sectors; (ii) an upward revision of 2010 GDP due to a higher than anticipated output of electricity generation from the Nam Theun 2 project; and (iii) the commencement of operations at the Nam Ngum 2 hydropower dam. The mining sector's contribution to growth in 2011 is expected to slow according to company production plans and actual outputs in the first 3 quarters of this year. The manufacturing sector is projected to grow at 15 percent driven by garment, construction materials, and food and beverage production. The garment sector started shifting production towards higher value-added products and began benefiting this year from the EU relaxing material sourcing regulations for LDCs. The services sector is also benefiting from higher domestic demand, particularly for wholesale, retail trading and telecommunications.

Headline inflation has decelerated in the past few months due to slower growth in food prices. Headline inflation dropped from a peak of 9.8 percent in May to 6.6 percent (YOY) in October. Food inflation dropped to 8.1 percent (YOY) in October 2011 from a peak of 14 percent in May 2011. This followed a fall in the price of rice due in part to a high base effect from last year and the government's policy to use rice reserves. Nevertheless, this trend is expected to temporarily reverse following the recent typhoons' impact on Lao PDR agriculture as well as the recent flood in Thailand. The prices of meat, poultry, and fish remained high in recent months due to the effects of the typhoons on livestock production and the disruption of supply of meat, poultry and fish to consumers. Energy inflation has trended lower but the level remained high at about 26.2 percent in October 2011, following international trends. Core inflation increased to 5 percent (YOY) in October 2011 driven by strong domestic demand, particularly in housing, water and electricity, and tourism. With growing uncertainty in the global markets and flooding in neighboring countries (Lao PDR's major trading partners), inflationary pressure is likely to stem from international oil and other commodity price movements as well as the pace at which Lao PDR and neighboring countries recover after the severe flooding this year.

With large public revenues from mining and hydropower flowing into the fiscal accounts and the reduction of off-budget expenditures, the GOL's fiscal deficit has reduced significantly. The total fiscal deficit in FY10/11 is estimated to drop to 2 percent of GDP from 4.6 percent in FY09/10 while the non-mining and non-resource deficits are expected to decline from 10.7 and 11.1 percent in FY09/10 to 9.7 and 10.4 percent in FY10/11 respectively. Off-budget spending is expected to decline from 2.8 percent of GDP (about 1.6 trillion kip) to 1.4 percent (more than 800 million kip) in the same period. Although off-budget spending is on a declining trend, data shows that lending to such infrastructure projects remains relatively high and should be monitored closely. Total domestic revenues are expected to exceed the target for this fiscal year and increase to 15.2 percent of GDP in FY10/11 from 14.2 percent in FY09/10. Resource revenues are likely to double from 2.1 percent of GDP in FY09/10 to 4.2 percent in FY10/11 following a surge in commodity prices. However, there is concern for non-resource revenue slowdown as non-resource revenues to GDP dropped to 11 percent in FY10/11 from 12.2 percent in FY09/10. Government spending is estimated to decline from 23.3 percent of GDP to 21.4 percent in FY10/11 following the reduction of quasi-fiscal expenditures. The Government is committed to a low budget deficit with fiscal targets of about 16.2 percent of GDP for domestic revenue (excluding grants) and 22.6 percent of GDP for expenditure in FY2011/12. The stock of external PPG debt declined to 51.8 percent of GDP in 2010 from 82 percent in 2005 supported by strong economic growth, the appreciation of the kip, and favorable external conditions. Nevertheless, the risk of debt distress remains high according to the latest June 2011 Debt Sustainability Analysis, stemming from a relatively high level of debt outstanding against the backdrop of a high level of concessionality and low debt service ratios.

The overall balance of payment surplus is expected to narrow following the deterioration of the non-resource balance of payment (BOP) deficit while the resource BOP remains in surplus. The higher surplus in resource BOP continues to be heavily influenced by a few number of large projects (NT2, Nam Ngum 2, the Hongsa Lignite power plant, and Phubia mining) as i) the resource current account surplus declines because the larger net income transfer abroad (dividend, profit repatriation and interest payments) from the mining sector offsets the increase resource trade surplus; and ii) the resource capital account surplus is expected to accumulate following the construction of the Hongsa Lignite power plant and four other smaller hydropower projects as well as gold-silver production expansion by Phubia. By contrast, the non-resource BOP deficit is getting wider as i) the non-resource current account deficit increases because non-resource imports of capital goods and consumption goods outweigh non-resource exports; and ii) the non-resource capital account surplus is rising quickly, following FDI inflows in non-resource sectors (agriculture, manufacturing and services) and Lao Stock Exchange portfolio investments. However, non-resource FDI inflows are offset by a non-resource trade deficit, resulting in a wider non-resource balance of payment deficit. This leads to a decline in overall BOP surplus from 1.3 percent of GDP in 2010 to just 0.2 percent in 2011.

Net foreign assets and foreign exchange reserves accumulated as of June 2011, as a result of buoyant economic activities and a stabilized exchange rate policy. Foreign exchange reserves have increased by 28.7 percent (YOY), reaching $719 million in June 2011 following inflows of foreign investments and export earnings. Net foreign assets grew rapidly by 54 percent (YOY) reaching $911 million in June 2011 from $576 million in June 2010. Such increases in reserves and NFA are partly a result of the slowdown of credit growth (see Lending Section). The levels of reserves and NFA are projected to slightly climb to around $750 million and $950 million respectively by the year-end. This slight increase is explained by the offset from large imports despite estimated strong capital inflows and export earnings.

The government continues its policy of a stabilized exchange rate against major currencies. The Lao kip exchange rate has slightly appreciated against the US dollar and the Thai baht during the last six months (May 2011 – October 2011), mostly on the account of the appreciation of the US dollar against major currencies during the past few months. The kip's appreciation against the Thai baht has been notable, especially during the last three months due to the recent depreciation of the Thai baht against major currencies, especially the US dollar.

Credit growth continues to slow in 2011. Credit growth has decelerated to 33.2 percent (YOY) in June 2011 compared to almost 63 percent in June 2010 and 46 percent in December 2010. This was attributed to the reduction of BOL direct lending to infrastructure projects and slower credit growth to the private sector. The latter slowdown is primarily due to constrained bank liquidity for long term credits (due to insufficient long term deposits, although overall deposit increased by 42.5 percent (YOY) - mostly from short term deposits) and a base effect as credit has grown quickly in recent years. Non-performing loans were reported at 3 percent as of June 2011, which was similar to the end of 2010. Broad money (M2) expanded largely by 40.9 percent (YOY) in June 2011 from to 27.2 percent in June 2010, driven by strong overall deposit growth and solid economic performance. In order to curb inflationary pressures, the BOL issued about $340 million worth of BOL securities to absorb excess liquidity while reserve requirements were left unchanged. The de-dollarization rate was a bit lower at 44.5 percent in June 2011 compared to 46.2 percent in end-2010.

1 These include: Nam Ngiep 2 (180MW), Nam Khan 2 (145MW), Houay Lamphan-Gnai (88MW) and Xe Kaman 1 (64MW) hydropower projects.

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Note: all dollar figures are in US dollars unless otherwise indicated.

RECENT ECONOMIC DEVELOPMENTS

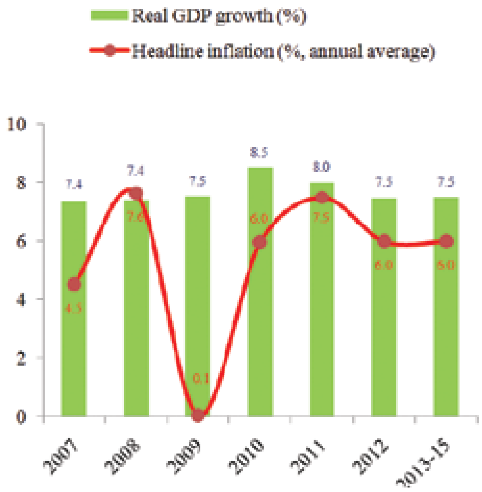
With significant challenges and risks ahead - increasing uncertainties, particularly on signs of spreads of debt concerns in Europe, over-heating in emerging economies (high inflation) and price volatility, global economic growth is projected to slow in 2011 and 2012. Emerging and developing economies are projected to experience healthy growth in the near term. Challenges lie on two main fronts, i.e. rebalancing from public to private demand, particularly in advanced economies and rebalancing domestic demand, particularly in emerging and developing economies in order to promote resilience to external shocks and further reduce inflationary pressures. This paper bases its country-level projections for Lao PDR's FDI and export demand on IMF (WEO Sep 2011) and the World Bank's projections (EAP Update Nov-2011) for the regional and global economic outlook and commodity prices, as presented in Annex 1.

1. GROWTH AND INFLATION

The Lao PDR economy continues to grow vigorously at 8 percent this year despite the impact of typhoons and slower growth in the global economy. That being said, the growth estimate was revised slightly downwards to 8 percent from an early estimate of 8.6 percent to account for (i) the adverse impact on agriculture by the typhoons Haima and Nock Ten during the second half of the year, as well as the adverse impact of the current flooding in Thailand on Lao PDR's tourism and trade sectors; (ii) an upward revision of 2010 GDP due to a higher than anticipated output of electricity generation from the Nam Theun 2 project; and (iii) the commencement of operations at the Nam Ngum 2 hydropower dam. The mining sector's contribution to growth in 2011 is expected to slow according to company production plans and actual outputs in the first 3 quarters of this year. The manufacturing sector is projected to grow at 15 percent driven by garment, construction materials, and food and beverage production. The garment sector started shifting production towards higher value-added products and began benefiting this year from the EU relaxing material sourcing regulations for LDCs. The services sector is also benefiting from higher domestic demand, particularly for wholesale, retail trading and telecommunications.

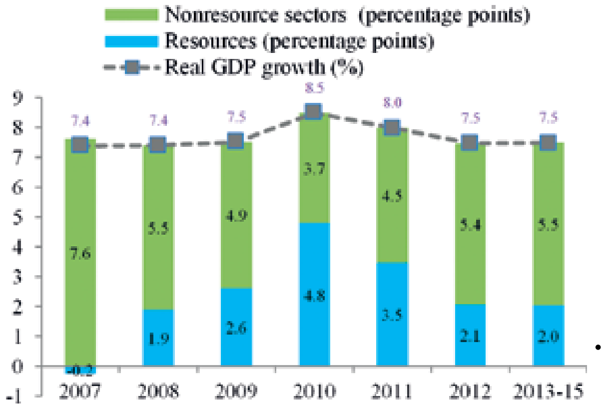
Heightened uncertainty in the global economy (price volatility, the debt crisis in Europe, and a slowdown in China's economic growth) has led to a revision of Lao PDR's medium term growth projections down to 7.5 percent a year on average from 2012 to 2015, compared to an early estimate of 8 percent. This projection is based on the assumption of i) a dynamic growth in non-resource sectors (manufacturing, such as garment and other processing industries; crops plantation; construction; tourism; banking and other services); ii) the successful implementation of large mining and hydropower projects under construction and in the pipeline (such as the ongoing expansion of the Phu Kham copper-gold and the Houayxai gold-silver projects by Phubia, the construction of the Hongsa Lignite Power Plant, Nam Ngum 5, Sekaman 3, Nam Ngum 3 and other medium sized projects in pipeline); and iii) a sustained demand for the country's main export products from the region and the EU.

Figure 1 Growth and Inflation, (percent change)



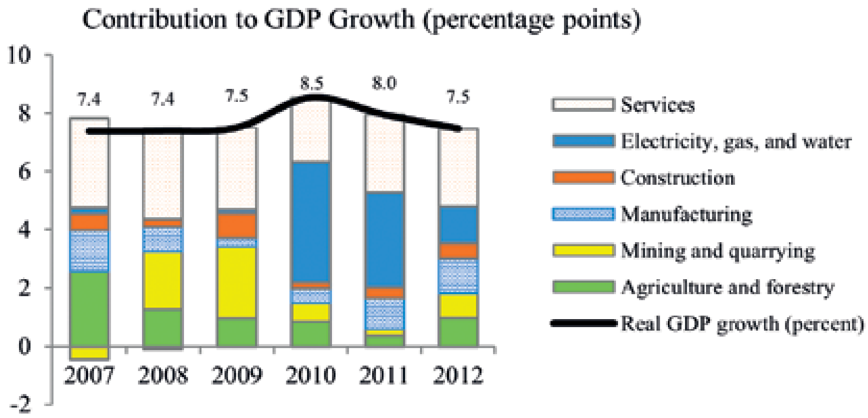
Source: MPI (LSB) and staff estimates and projections.
** Yearly average for 2013-15*

Figure 2 Resource Sectors Contribution to GDP Growth, (percentage points)



Source: MPI (LSB) and staff estimates and projections.
** Yearly average for 2013-15*

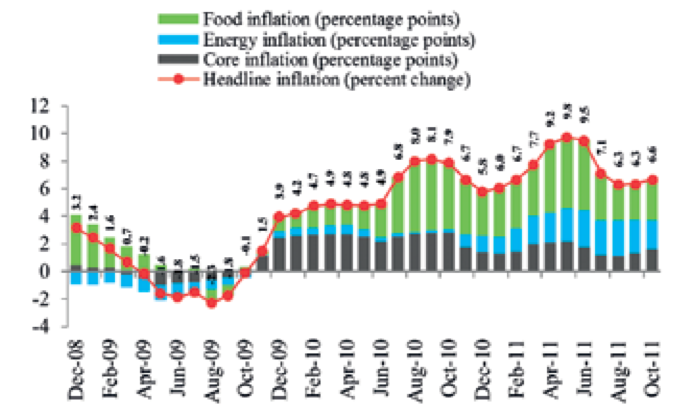
Figure 3 Real GDP Growth (at factor cost): Contribution by Sector (percentage points)



Source: MPI (LSB) and staff estimates and projections

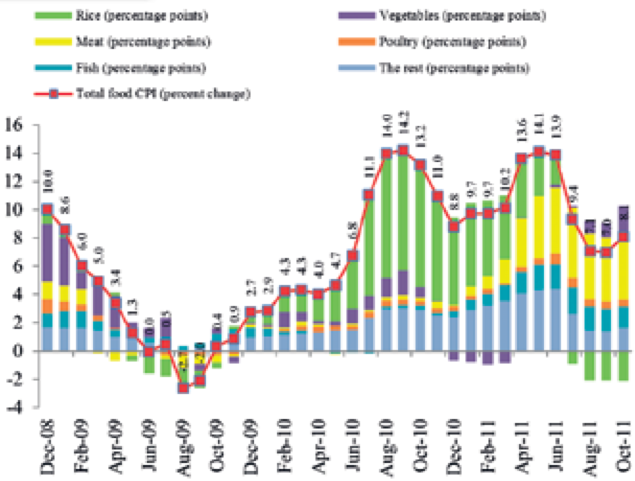
Headline inflation has decelerated in the past few months due to slower growth in food prices. Headline inflation dropped from a peak of 9.8 percent in May 2011 to 6.6 percent (YOY) in October 2011. Food inflation dropped to 8.1 percent (YOY) in October 2011 from a peak of 14 percent in May 2011 following a fall in the price of rice due in part to a high base effect from last year and the government's policy to use rice reserves. Nevertheless, this trend is expected to temporarily reverse following the recent typhoons' impact on Lao PDR's agriculture sector, as well as the recent flood in Thailand. The prices of meat and fish have remained high at around 14 percent (YOY) on average while poultry and vegetables prices reached around 8 percent (YOY) on average in recent months partially due to the effects of the typhoons on livestock production and the disruption of supply to consumers. Energy inflation remained high at about 26.2 percent (YOY) in October 2011, following international trends. Core inflation increased to 5 percent (YOY) in October 2011 driven by a strong domestic demand, in particular in housing (construction materials), water and electricity (demand and tariff adjustments), and tourism (hotels and restaurants). With growing uncertainty in the global markets and flooding in neighboring countries (Lao PDR's major trading partners), inflationary pressure is likely to stem from international oil and other commodity price movements as well as the pace at which Lao PDR and neighboring countries recover after the severe flooding this year.

Figure 4 Monthly Inflation (YOY percent change)



Source: MPI (LSB) and staff calculations.

Figure 5 Food Prices (YOY percent change)



Source: Lao PDR authorities (MPI) and staff calculations

Box 1. Impacts of typhoons Haima and Nock Ten on Lao PDR agriculture and food prices, and GOL's mitigation measures.

The impact of recent tropical regional typhoons Haima and Nock Ten (in July and August 2011) on agriculture is significant. It is estimated that about 89,348 hectare of crops (13% of the total farming area) were damaged and the loss of planted areas may cause a reduction of approximately 0.3 million tons of paddy rice this year, or about 10% of the production target. It is possible that the next dry season may help mitigate some of the impact depending on how quickly all damaged irrigation systems (about 309 irrigation systems in the major rice producing provinces) can be restored. In addition, recent severe flooding in neighboring countries (Cambodia, Thailand and Vietnam) is likely to put more pressure on food prices in Lao PDR.

The GOL has made it a priority to restore the affected areas. Short term and medium term measures have been taken to mitigate the impact (although budget constraints remain an issue). About 100 billion kip from the state accumulation fund has been initially allocated to restore flooded areas in 12 provinces across the country (of which 30 billion kip to agriculture). In addition, the GOL has also increased the rice stockpile to 30,000 tons to ensure food security and combat food inflation in the coming months. It is estimated that the sector will require about 170 billion kip in the medium-term for full recovery. The GOL is working closely with development partners to mobilize resources needed to fill the gap.

Source: GOL/MOAF

2. GOVERNMENT'S REVENUE AND EXPENDITURE

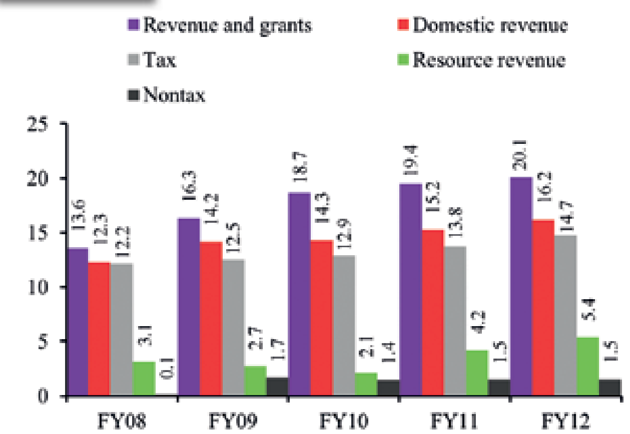
With large public revenues from mining and hydropower flowing into fiscal accounts and the reduction of off-budget expenditures, the GOL's fiscal deficit has reduced significantly. The total fiscal deficit in FY10/11 is estimated to drop to 2 percent of GDP in FY10/11 from 4.6 percent in FY09/10. Off-budget spending is expected to halve from 2.8 percent of GDP (about 1.6 trillion kip) in FY09/10 to 1.4 percent (more than 800 million kip) in FY10/11. Although this off-budget spending has declined, it is considered to have remained relatively high. The non-mining and non-resource deficits are expected to decline from 10.7 and 11.1 percent in FY09/10 to 9.7 and 10.4 percent in FY10/11 respectively. Total domestic revenues are estimated to exceed the target for this fiscal year and increase to 15.2 percent of GDP in FY10/11 from 14.2 percent in FY09/10. Resource revenues are likely to double from 2.1 percent of GDP in FY09/10 to 4.2 percent in FY10/11 following a surge in commodity prices.

This hides a more worrisome trend. With non-resource revenues collection experiencing a marked slowdown, non-resource revenues are expected to record only a small increase in nominal terms of 3.2 percent. A fall is expected, as a share of GDP is estimated at 11 percent in FY10/11 from 12.2 percent in FY09/10. This signals a need for attention to non-resource revenues. Non-resource revenues primarily come from i) an incremental contribution from VAT (through an increase in the number of registered taxpayers from 1900 units in 2010 to 2300 units to date), and ii) excise tax through increased imports. Maintaining the tax effort on the non-resource base of the economy is critical not only to shield the fiscal accounts against volatility of mining revenues, but also to maintain diversification of public revenue to avoid dependence on a limited number of mega-projects, and social accountability between tax payers and the government.

Government spending is estimated to notably decline following the reduction in quasi-fiscal expenditures. As a result, total fiscal outlays are estimated to decrease to 21.4 percent of GDP in FY10/11 compared to 23.3 percent in FY09/10. Capital spending is estimated to fall from 12.1 percent of GDP in FY09/10 to 10.2 percent in FY10/11 following the reduction in off-budget spending from 2.8 percent of GDP (about 1.6 trillion kip) to 1.4 percent (more than 800 million kip) in the same period. Although off-budget spending is on a declining trend, data shows that lending to such infrastructure projects remain relatively high and should be monitored closely. On current expenditure, compensation and transfers have increased in order to promote expansion of social public services to remote areas. This was supported by the Prime Minister's Decree on Incentive Provision to Civil Servants Working in Rural and Inaccessible Area (approved in November 2010 and commenced from Q3 FY10/11 onward). In addition, the GOL has drawn down its contingency and state accumulation fund to address immediate needs stemming from the natural disasters, such as flooding and typhoons.

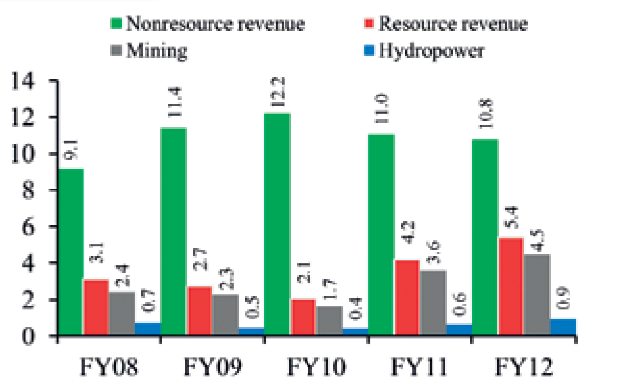
The Government is committed to a low budget deficit policy in the coming years. The FY11/12 budget plan, approved by the National Assembly in June 2011, targets a deficit of below 3 percent (with set targets of about 16.2 percent of GDP for domestic revenue – excluding grants, and 22.6 percent of GDP for expenditure). The GOL is taking the following measures to ensure the achievement of revenue targets: i) strengthening revenue centralization and administration; ii) tightened administration of technical revenue ; iii) closely monitor leakages associated with imports of vehicles and fuels for investment projects; and iv) improved implementation of taxation legislations, including VAT and the revised tax law. In addition to these planned measures, higher government revenue is anticipated following revenue collection from the mining sector associated with a projected increase in metal prices and output expansion.

Figure 6 **Domestic Revenues (percent of GDP)**



Source: MOF and staff estimate and projection

Figure 7 **Resource Revenues (percent of GDP)**

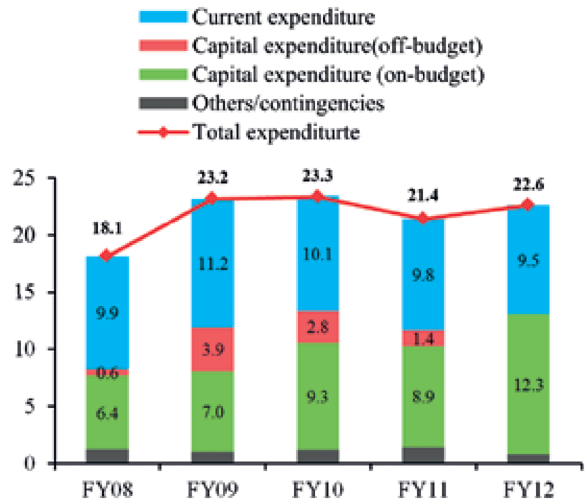


Source: MOF and staff estimate and projection

2 The fund was created in 2006 to allow a quick response to immediate needs following emergencies such as economic crisis or natural disasters. The Budget Law provides the framework within which the fund resources may be used.

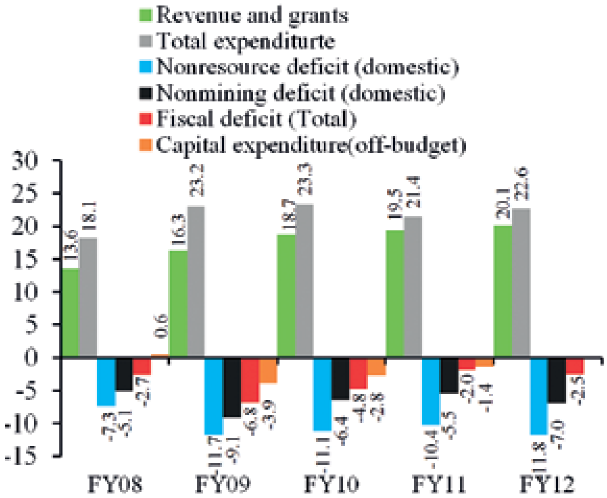
3 In accordance with the Presidential Decree No. 03 and MOF Instruction No. 0727/mof dated 20 April 2010. Technical revenue is considered a non-regular revenue base. Accumulated amount of 442 billion kip was accounted for in FY09/10. However, the amount has declined to 220 billion kip in FY11/12, as majority has already been accounted for.

Figure 8 **Key Fiscal Expenditures (percent of GDP)**



Source: MOF and staff estimate and projection

Figure 9 **GOL's Fiscal Performance (percent of GDP)**



Source: MOF and staff estimate and projection.

Public Debt

Table 1

External Public and Publically Guaranteed Debt at end 2010

	Indicative Threshold	Lao PDR 2008	2009	2010
Nominal PPG (% of GDP)		54	55.4	51.8
Present value of PPG, (% of GDP)	30	...	...	36.6
PPG Debt Service, (% of)				
Exports	15	4.3	4.9	4.5
Revenue	25	11.4	10.8	11.5

Source: IMF/World Bank Debt Sustainability Analysis 2011

The risk of debt distress remains high while debt services remain comfortably below the thresholds. The stock of external PPG debt declined to 51.8 percent of GDP from 82 percent in 2005 supported by strong economic growth, appreciation of kip, and favorable external conditions. Nevertheless, the risk of debt distress remains high according to the latest June 2011 Debt Sustainability Analysis, stemming from a relatively high level of debt outstanding against the backdrop of a high level of concessionality and low debt service ratios.

3. EXTERNAL BALANCE

The overall surplus of the balance of payment is expected to narrow to just 0.2 percent in 2011 from 1.3 percent of GDP in 2010. This follows the deterioration of the balance of payment deficit in the non-resource sectors and the increase balance of payment surplus in the resource sector.

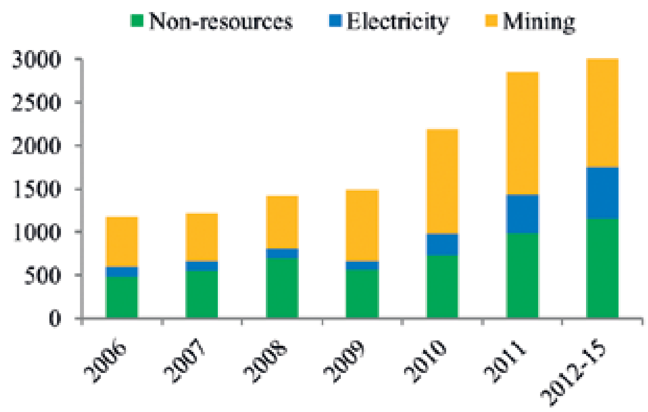
The balance of payment in the resource sectors (mining and hydropower) continue to be heavily influenced by a few number of large projects (NT2, Nam Ngum 2, the Hongsa Lignite power plant, and Phubia mining) and is expected to be in surplus. The resource trade balance is projected to record a surplus of $1,020 million this year up from $840 million in 2010, since exports in hydro and mining outgrow imports in the sector. This improvement in the resource trade balance is expected to be more than offset by a large increase in net income transfers abroad (dividend and profit repatriation, interest payments) flowing out of the mining sector and leading to a net decline of the current account surplus in the resource sectors from 5 percent in 2010 to 4.6 percent of GDP in 2011. Resource exports are projected to grow by 27.4 percent reaching $1.8 billion in 2011. This is higher than expected, primarily driven by electricity (due to NT2 electricity output and the commencement of Nam Ngum 2) and mining exports (associated with a rise in the value of copper and gold). The construction of the Hongsa Lignite power plant and four

other smaller hydropower projects , as well as gold-silver production expansion by Phubia are driving up capital goods imports (by about 38 percent in 2011), largely financed from FDIs in the sector. As the result, the capital account surplus of the resource sectors is projected to rise to 10 percent of the GDP in 2011 from 7.3 percent in 2010. Overall, the balance of payment in hydropower and mining is projected to record a surplus of $1,220 million, or 14.6 percent of the GDP, contributing to the accumulation of official reserves.

The non-resource current account deficit is expected to worsen to 18.6 percent of GDP this year from 14.1 percent in 2010, mostly on the account of deterioration of the non-resource trade deficit. The deficit is anticipated to reach about $2,050 million in 2011, compared to $1,500 million in 2010. Non-resource exports (mainly from manufacturing, such as garments; wood and timber products; agriculture and agro-processing sectors) are expected to grow by 21 percent or about $820 million in 2011. Garment exports have continued to grow by a little more than 15 percent in 2011, following a gradual shift of production towards higher value-added products and a reform on GSP Rule of Origin offered by the EU market effective from January 2011. Exports of wood and wood products are also expected to rebound due to increased demand from neighboring countries. Agriculture exports (primarily coffee, maize and non-rice crops, and vegetables) are estimated to grow at a slower pace by 15 percent following the recent typhoons and flooding in the country. Non-fuel non-resource imports will grow faster than exports at 25.1 percent this year fueled by capital import for the non-resource sector (including the purchase of two Airbus aircrafts) and consumption goods. Fuel and gas imports are quickly growing at 43 percent this year driven by increased demand and price. Consumer goods imports are estimated to grow by 28 percent.

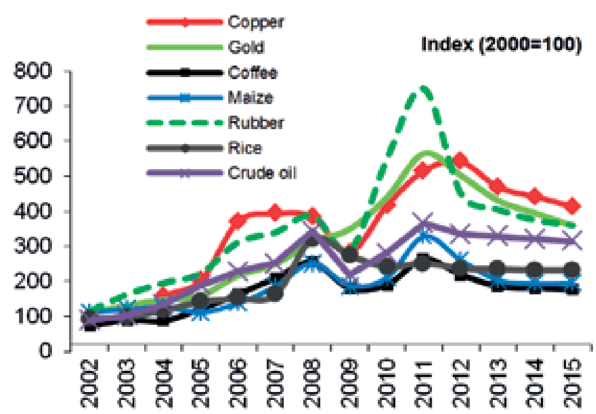
Investment in the non-resource sectors are also rising fast, but not enough to offset the large current account deficit in the non-resource sectors, leading to widening of overall balance of payment deficit in the non-resource sectors to 14.3% of GDP. FDI inflows in non-resource sectors (agriculture, manufacturing, and services) are also rising quickly, but unlikely to offset the rise in non-resource trade deficit. Net portfolio investment through the Lao Stock Exchange is estimated to be around $80 to $100 million this year and will continue to grow in 2012 with new companies anticipated to enter into the market and additional IPOs (worth about $200 million) from EDL-Gen. As a result, the non-resource capital account surplus is projected to rise to 4.3 percent of GDP in 2011 from 3.1 percent in 2010.

Figure 10 **Merchandise Exports (US$ million)**



Source: Staff estimates and projections based on data from Lao authorities (MOIC) and partner countries

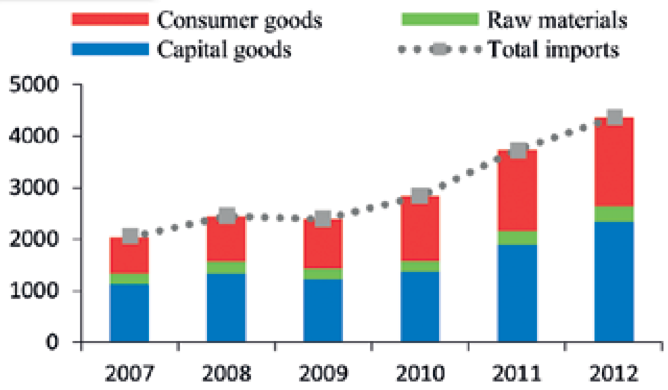
Figure 11 **World Commodity Prices**



Source: WB DECDG's recent estimates and projections.

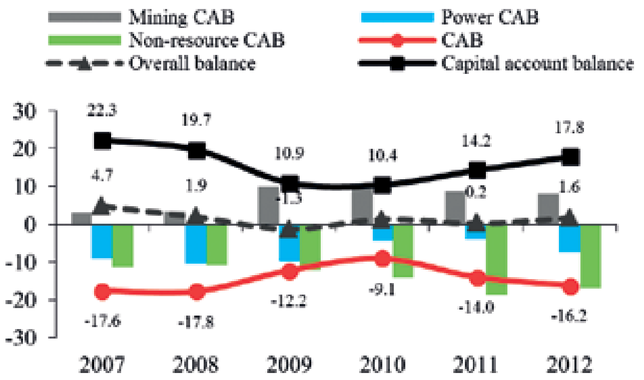
4 These include: Nam Ngiep 2 (180MW), Nam Khan 2 (145MW), Houay Lamphan-Gnai (88MW) and Xe Kaman 1 (64MW) hydropower projects.

Figure 12 Merchandise Imports (US$ million)



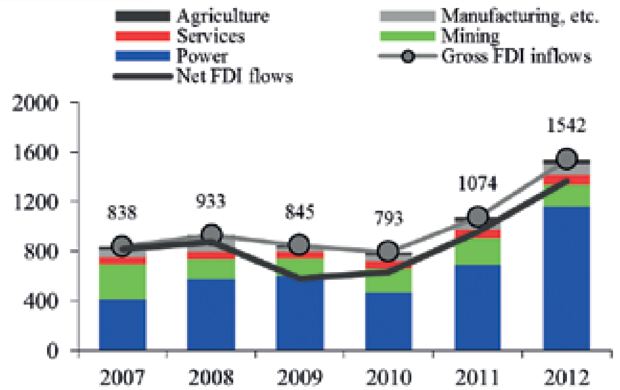
Source: Staff estimates and projections based on data from Lao authorities (MOIC) and partner countries.

Figure 13 Balance of Payments (percent of GDP), 2007-12



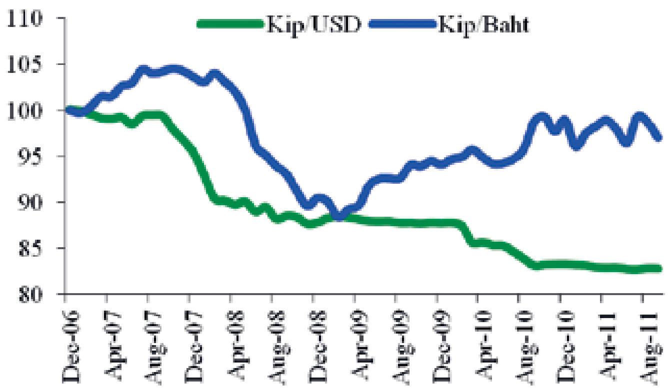
Source: BOL and staff estimates and projections.

Figure 14 FDI in Lao PDR, 2007-12 (US$ million)



Source: MPI and staff estimates and projections.

Figure 15 Kip Exchange Rate (Index Dec-2006 =100)



Source: Lao PDR authorities (BOL) and staff calculations.

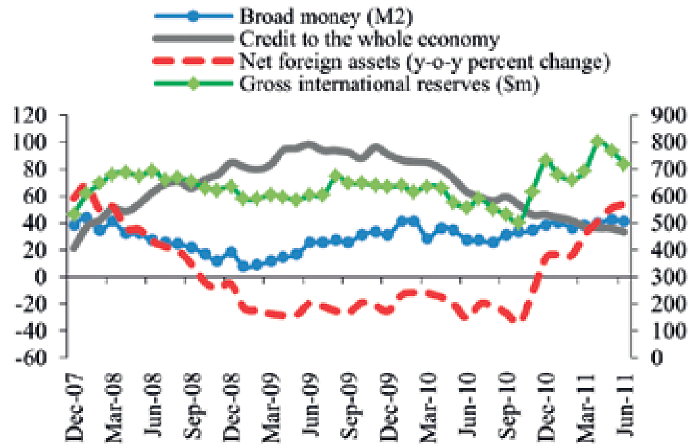
4. MONETARY SECTOR

Exchange Rate

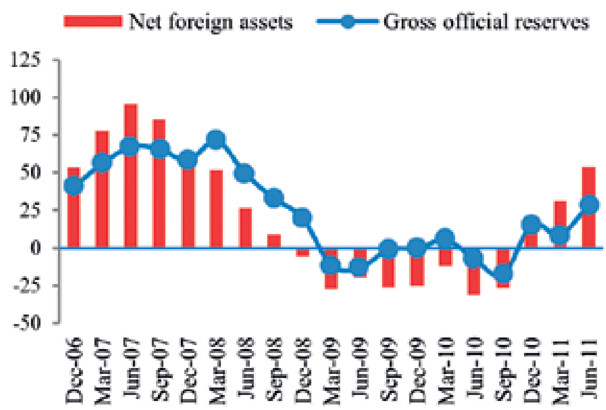
The government continues its policy of a stabilized exchange rate against major currencies. The Lao kip (LAK) exchange rate has slightly appreciated against the US dollar and the Thai baht during the last six months (May 2011 to October 2011), primarily as a result of the appreciation of the US dollar against major currencies during the past months. The kip's appreciation against the Thai baht has been notable, especially during the last three months due to recent depreciation of the Thai baht against major currencies, especially the US dollar.

Net foreign assets and foreign exchange reserves accumulated as of June 2011, as a result of buoyant economic activities and the stabilized exchange rate policy. Foreign exchange reserves have increased by 28.7 percent (YOY), reaching $719 million in June 2011 following inflows of foreign investments and export earnings. The reserve level in 2011 is projected to cover about 3.8 months of non-resource imports. In the same time, net foreign assets grew rapidly by 54 percent (YOY) reaching $911 million in June 2011 from $576 million in June 2010. Such increases in reserves and NFA are partly explained by the slowdown of credit growth (see Lending Section). The levels of reserves and NFA are projected to slightly climb to around $750 million and $950 million respectively by the year-end. This slight increase is explained by the offset from large imports despite estimated strong capital inflows and export earnings.

Figure 16 **NFA and international reserves have increased** **(yoy percent change)**



Source: BOL and staff estimate



Source: BoL and WB staff estimate

Monetary Developments

Credit growth continues to slow in 2011 on the account of a base effect following rapid expansion over the past years, and further decline of the BOL disbursement to local projects (SOE lending). Credit growth has decelerated from almost 63 percent in June 2010 to 46 percent in December 2010 and to 33.2 percent (YOY) in June 2011. The credit growth is projected to grow at around 30 percent by the end of 2011. This deceleration may be explained by slower credit growth for the private sector (from 56 percent in June 2010 to 31.9 percent in June 2011), due to constrained bank liquidity for long-term credits. This is also due to insufficient long-term deposits, despite the fact that overall deposits (mostly short-term deposits) increased by 42.5 percent (YOY). In addition, the deceleration is also derived from a mechanic impact of a base effect as credit has grown quickly in recent years. BOL disbursement to local projects (recorded as lending to SOEs in the monetary survey) remains significant (0.9 percent GDP or LAK 635 billion during the first half of 2011, estimated to reach up to 1.5 percent by the end of 2011). The authorities have committed through the Budget execution instruction No. 2419/mof dated October 4 2010 to abide to the national assembly's approved budget and to reduce this quasi-fiscal spending, which has added to domestic public debt. Non-performing loans were reported at 3 percent as of June 2011, about the same level of end-2010.

Net foreign asset coverage has been steadily declining since 2008. While the coverage has remained at comfortable levels, the monetization and de-dollarization of the economy have deepened (Figure 19 and Figure 20). Broadly speaking, foreign asset coverage indicators provides a rough measure of the ability of the financial sector to meet foreign exchange demand, the extreme case being currency boards, where 100 percent of the monetary base is backed up by foreign exchange. The economy continues its process of financial deepening and mon-

etization accompanied with de-dollarization. The de-dollarization rate was 44.5 percent in June 2011 compared 46.2 percent in end-2010, reflecting slower kip deposits compared to foreign currency deposits due to strong inflows from FDI and exports. However, looking at the development over time, while foreign exchange deposits have almost doubled since June 2008, LAK denominated deposits have grown by more 2.5 times (Figure 19). Broad money (M2) expanded largely by 40.9 percent (YOY) in June this year from to 27.2 percent in June last year driven by strong overall deposit growth and solid economic performance. In order to curb inflationary pressures, the BOL issued approximately $340 million worth of BOL securities to absorb excess liquidity while reserve requirements were left unchanged.

Figure 17 Credit growth continues to slow in 2011

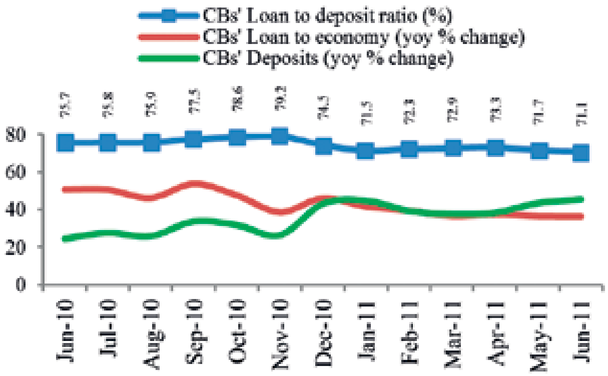


Figure 18 Contribution to Credit Growth (percentage points)

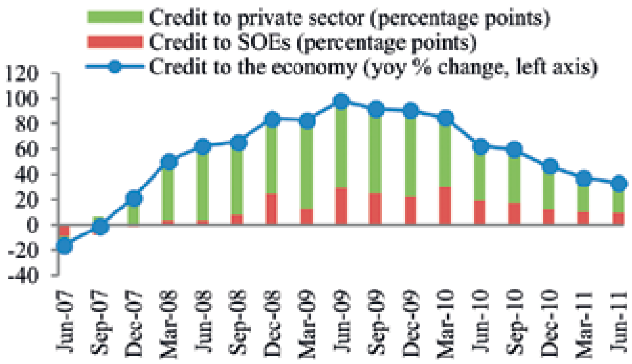


Figure 19 Net foreign asset coverage (%)

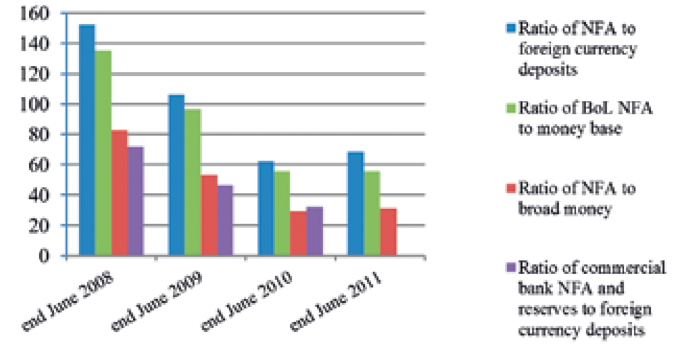
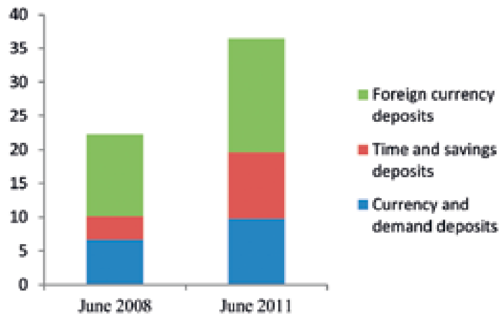


Figure 20 Financial deepening and de-dollarization of the economy (Percaent of GDP)



5 In the context of Lao PDR, de-dollarization rate is the ratio of kip deposit to the total deposit (This simple formula is used by BOL as a proxy for estimating the de-dollarization rate in the country due to data limitation on the composition of kip and foreign currencies out side the bank).


2004

Annex 1 THE GLOBAL ECONOMIC OUTLOOK IN SUMMARY

(percentage change from previous year, unless otherwise specified)

	2008	2009e	2010e	2011f	2012f
Global conditions					
Global conditions					
World Output 1/	3.0	-0.7	5.1	4	4
World trade volume	3.0	-10.7	12.8	7.5	5.8
Consumer prices					
Advanced Economies	3.4	0.1	1.6	2.6	1.4
Emerging and Developing Economies 2/	9.3	5.2	6.1	7.5	5.9
Commodity prices (percentage change of USD terms)					
Non-oil commodities 3/	7.5	-15.7	26.3	21.2	-4.7
Oil price 4/	36.4	-36.3	27.9	30.6	-3.1
London Interbank Offered Rate (%) 5/					
on USD Deposits	0.9	1.1	0.5	0.4	0.5
on Euro Deposits	0.4	1.2	0.8	1.3	1.2
On Japanese Yen Deposits		0.7	0.4	0.5	0.3
Real GDP growth					
World	3.0	-0.7	5.1	4.0	4.0
Advanced Economies	0.6	-3.7	3.1	1.6	1.9
United States	0.4	-3.5	3.0	1.5	1.8
Euro Area	0.7	-4.3	1.8	1.6	1.1
Japan	-0.7	-6.3	4.0	-0.5	2.3
United Kingdom	0.7	-4.9	1.4	1.1	1.6
Emerging and Developing Asian Economies	6.0	2.8	7.3	6.4	6.1
Developing Asia	7.6	6.2	9.5	8.2	8.0
China	9.0	8.5	10.3	9.5	9.0
India	7.3	5.4	10.1	7.8	7.5
Indonesia	6.1	4.0	6.1	6.4	6.3
Thailand	2.6	-3.5	7.8	3.5	4.8
Middle East and North Africa	5.2	2.6	4.4	4.0	3.6

Source: IMF (WEO, Sept 2011)

Note:

1/ The quarterly estimate and projections account for 90 percent of the world purchasing power parity weights

2/ The quarterly estimates and projections account for approximately 79 percent of the emerging and developing economies

3/ Average based on commodity export weight

4/ Simple average of prices of UK Brent, Dubai, and West Texas Intermediate crude oil. The average oil price was US$ 79.03 a barrel in 2010; the assumed price based on futures markets is US$103.2 in 2011 and US$100.00 in 2012.

5/ Six-month rate for the US and Japan. Three month rate for the Euro Area

Annex 2 LAO PDR AT A GLANCE

*Key development Indicator **	Lao PDR	East Asia & Pacific	Low income	
2010				
Population, mid-year (millions)	6.4	1,944	846	
GNI (Atlas method, US$ billions)	6.4	6,149	431	
GNI per capita (Atlas method, US$)	1010	3,163	509	
GNI per capita (PPP, international $)	2,200	6,026	1,220	
GDP growth (%)	8.5	7.4	4.6	
GDP per capita growth (%)	6.6	6.6	2.4	
				Proj.
Local Prices	**2008**	**2009**	**2010**	**2011**
Consumer prices (annual % change)	7.6	0.1	6.0	7.5
Implicit GDP deflator	9.6	0.1	9.4	4.1
Exchange rate (period average, kip per 1 US$)	8635	8498	8235	8052
Structure of the Economy				
GDP (US$ millions)	5478	5903	7302	8421
Agriculture (% of GDP)	33.4	31.9	30.2	28.4
Industry (% of GDP)	27.3	28.9	31.6	33.8
Services (% of GDP)	39.4	39.2	38.2	37.8
Balance of Payments and Trade		***(US$ millions)***		
Exports of goods (fob)	1419	1489	2148	2693
Imports of goods (cif)	2455	2369	2811	3728
Exports of goods and services	1743	1801	2552	3111
Imports of goods and services	2571	2493	2960	3898
Net trade in goods and services)	-828	-692	-408	-786
Current account balance (% of GDP)	-17.8	-12.2	-9.1	-14.0
Non-resource current account (% of GDP)	-10.8	-12.2	-14.1	-18.6
Reserves, excl. gold	626	633	730	750
Government Finance (FY)		***(% of GDP)***		
Total revenue (including grants)	13.6	16.3	18.7	19.4
Revenue	12.3	14.2	14.3	15.2
Tax revenue	12.2	12.5	12.9	13.8
Current expenditure	9.9	11.2	10.1	9.8
Overall surplus/deficit	-2.7	-6.8	-4.8	-2.0
External Public Debt and Resource Flows				
Total external public debt (% of GDP)	54.0	55.4	51.8	46.7
Total external debt service (% of exports)	11.0	11.8	13.4	12.8
Foreign direct investment (US$ millions)	933	845	793	1074

Source: World Development Indicators and staff estimates based on Lao authorities data.
** Preliminary estimates for 2011*

Annex 3 ACRONYMS AND ABBREVIATIONS

BOL	Bank of Lao PDR
CPI	Consumer Price Index
EAP	East Asia & Pacific
EdL	Electricité du Laos
EU	European Union
FDI	Foreign Direct Investment
FY	Fiscal Year
GDP	Gross Domestic Product
GOL	The Government of Lao PDR
GSP	Generalized System of Preferences
IMF	International Monetary Fund
LDC	Least Developed Country
NFA	Net Foreign Assets
NPL	Non-Performing Loan
NSEDP	National Socio-Economic Development Plan
NT2	Nam Theun 2 Project
SOE	State-Owned Enterprise
PPG	Public and Public Guaranteed Debt
VAT	Value Added Tax
WB	World Bank
WEO	World Economic Outlook
YOY	Year on year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