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On behalf of our Lao PDR authorities, we thank staff for the candid dialogue and thorough policy assessment. Recovery in the Lao economy since the end of 2021 has continued well into 2022, despite new pressures as a result of the difficult external environment. Depreciation of the Lao kip against major currencies such as the US dollar and Thai baht, amid already rising food and energy prices resulted in high inflation, raised the cost of living for Lao people and increased the domestic currency values of public debt.

Against this backdrop, the authorities remain committed to improving public finances and easing foreign exchange pressures in line with the National Agenda to address economic and financial difficulties, at the same time promoting private sector-led growth by creating a more favorable business climate and accelerating governance and public administration reforms in line with the National Socio-Economic Development Plan for 2021-2025 (9^{th} NSEDP).

<u>**Economic developments and outlook**</u>

Real GDP growth in Lao PDR increased to 4.4 percent in 2022, and is expected to grow to 4.5 percent in 2023, driven by the return of tourists, goods trade following railway and trade agreements, and future development of resource sectors, including new hydroelectric power plants. In particular, the opening of the Lao-China high-speed railway and the Thanaleng Dry Port boosted the transport and logistics sectors, resulting in an increase in wholesale and retail trade. For the first eight months of 2022, the Lao section of the Laos- China railway carried more than 1 million tons of cross-border goods, including manufacturing, agriculture and mining products. This is expected to trend up as the re- opening of China and on-going implementation of the Regional Comprehensive Economic Partnership (RCEP) should further boost external demand for Lao products.

Implementation of infrastructure projects under the 9^{th} NSEDP will provide support for growth into the medium term. New road and rail transport system links facilitate the movement of people and goods across borders. These include connecting the domestic transport and logistics system with the Laos-China railway, ASEAN railway network (Singapore-Kunming Rail Link), and regional and international networks (Trans-Asian Railway). The Government has also set an ambitious target of 15.8 percent annual growth for electricity generation, which could be achieved by expanding electricity transmission and distribution system both within and across borders, streamlining investment regulations, and enhancing human resource capacity to provide sustainable and reliable electricity supply.

The promotion of private investment would further enhance economic diversification and inclusive growth. The authorities have enhanced investment facilitation by strengthening the implementation of one-stop investment service center and two Prime Minister’s Orders aimed at streamlining investment procedures and regulations. They have also developed 12 Special Economic Zones (SEZ) and provided the necessary infrastructure to attract more foreign direct investment, while strengthening linkages between foreign- owned firms in SEZs and local firms to raise local firms’ productivity and competitiveness. Moreover, the authorities are undertaking measures to achieve a well-functioning labor market through the development of Labor Market Information Systems and implementation of Active Labor Market Programs.

These positive developments notwithstanding, the authorities are cognizant of the need for firm policy action to address national economic and financial challenges. Official statistics show the depreciation in the Lao kip - calculated based on the percentage change of the average exchange rate in 2022 compared to that in 2021 – to be about 31.5 percent against the US dollar and 23.2 percent against Thai baht in 2022. The sharp currency depreciation together with higher prices of imported goods contributed to inflation rising to 23.0 percent in 2022, eroding living standards. The authorities reduced the excise tax on imported fuel to mitigate the burden of high fuel prices. The excise rate for diesel was reduced from 21 percent to 0 percent. The excise rate for regular gasoline was also reduced from 31 percent to 5 percent.

In addition, the authorities implemented a complementary combination of fiscal consolidation, tight monetary policy, and foreign exchange measures to address pressures on public finances and foreign exchange. These measures have contributed to a more stable exchange rate of Lao kip against the US dollar. The authorities agreed with staff on the need to continue to tighten monetary conditions in 2023 to contain inflation but were more optimistic than staff about the decline in inflation. They also expect that debt sustainability could be restored more quickly than projected by staff as economic growth and fiscal balances improve in the medium term.

Fiscal policy

The authorities remain committed to a tight fiscal stance by implementing fiscal consolidation through domestic revenue mobilization, the reduction of public expenditure, and debt payment deferral. Under the five-year budget plan, the authorities aim to minimize the fiscal deficit to 1 percent on average and not to exceed 3 percent.

On the revenue side, they have implemented the Prime Minister's Order on Enhancing Revenue Collection and Eliminating Revenue Leakage to expand the tax base and strengthen tax collection at border checkpoints. They have also rolled out various tax reform measures to improve revenue collection. Key measures include introduction of the Tax Revenue Information System (TaxRIS) and the integration of the Automated System for Customs Data (ASYCUDA) into TaxRIS, and connection with the database systems of line ministries and other relevant sectors including energy and mining, natural resources and environment, labor and social welfare and internal sector, to compile comprehensive tax base and revenue collection data.

Furthermore, the value-added tax rate will be increased from 7 percent to 10 percent after trial and reassessment. Legislation on land and construction tax, on environmental tax and amendments related to the collection of resource fees, concession fees and mineral export taxes will also be developed.

The authorities have initiated the Finlink system, which is a modern and centralized system to collect taxes and customs, fees and other public service charges. The Finlink is designed and approved to be the main link with the national retail payment operator, namely LAPNet, to reduce the cumbersome individual linkage with each payment service provider such as bank or fintech company. Once the system is officially launched, revenue collection is expected to increase and be more transparent.

The authorities have also streamlined public expenditure through implementation of the Prime Minister's Order on Streamlining Public Expenditure and the Decree on Enhancing the Efficiency of Public Expenditure and Assets. These legal instruments aim to enhance transparency in competitive tendering and accountability of public procurements; reduce unnecessary expenditure for public assets; design public investment consistent with planned public revenues; halt public investment projects that lack proper project appraisals or have low impact; and determine the ceiling of annual borrowings to finance public investment projects.

The combination of revenue and expenditure measures amid reopening of economic activities have contributed to public revenues growing faster than expenditure, and to the fiscal deficit falling sharply from -5.2 percent of GDP in 2020 to -1.2 percent in 2021 and -0.5

percent in 2022. The authorities are committed to sustain the fiscal deficit at low levels over an extended period to restore debt sustainability.

The authorities are in the process of revising the medium-term budget projections to increase the primary surplus. Additional sources of public revenues would come from closing leakages on import duties, new excises, the improvement of personal income tax collection, and expected revenue growth from the Thanaleng Dry Port. These will be complemented with the plan to strengthen the capacity of tax authorities on the oversight of e-tax systems and private sector capacity to provide accurate tax declarations.

Moreover, the authorities are negotiating the deferral of interest and principal servicing with bilateral creditors. Debt reprofiling and larger primary surpluses would reduce financing needs, the remaining of which would be sourced from sales of mining and hydroelectric concessions and fees, borrowing from commercial banks and domestic and external issuance of bills.

Monetary and exchange rate policies

The authorities have kept to a tight monetary stance by issuing bills, raising policy interest rate, and increasing reserve requirements for both kip and foreign currency- denominated deposits. In a country with multiple currency phenomenon – where foreign currencies are used in parallel with the Lao kip – and less developed financial market, the authorities have used multiple tools to contain inflation. The issuance of kip-denominated bills and an increase in the policy rate could reduce the money supply in kip, not the US dollar and Thai baht. The policy rate was raised from 3.1 percent in May 2022 to 6.5 percent in October and to 7.5 percent in February 2023. Meanwhile, the authorities increased reserve requirements for kip from 5.0 to 5.5 percent and for foreign currencies from 5.0 to 8.0 percent in 2023. The authorities stand ready to further tighten monetary conditions, but stress that this should be done gradually, in a way that supports economic recovery while keeping a close eye on containing inflation.

Moreover, the authorities have prioritized access to foreign exchange for fuel importing firms and closed foreign exchange bureaus. Prior to closures of foreign exchange bureaus, commercial banks sold foreign exchange to foreign exchange bureaus using the higher parallel market exchange rate, while restricting sale of foreign exchange to importing firms that by regulation must be transacted based on a daily reference exchange rate determined by the Bank of Lao PDR (BOL). This resulted in a large gap between the commercial bank rate and the parallel market rate. Following the BOL decision to close foreign exchange bureaus in January 2023, commercial banks should directly supply foreign exchange to importing firms who need it, using the commercial banks' exchange rate. This should enhance the mechanism of foreign exchange management and increase foreign exchange liquidity at commercial banks.

In June 2022, BOL issued its bills with the total value of 5 trillion kip for general public, and in February 2023 and March 2023, rolled over 2 trillion kip for general public and 1 trillion kip for open market operations. BOL also requested for technical assistance from IMF CDOT to help develop forecasting and policy analysis capabilities to facilitate BOL decision making and more effective monetary policy implementation.

Financial sector policies

The banking system remains profitable and well-capitalized. As of the third quarter of 2022, return on equity and return on assets reached 15.8 and 1.4 percent, respectively. Meanwhile, the regulatory capital to risk-weighted assets and the capital to asset ratios recorded at 18.5 and 14.6 percent respectively, way above the regulatory minimum of 8 percent. Non-performing loans remained low at 2.1 percent of total gross loans. BOL has plans to gradually phase out exemption implemented as part of COVID-19 measures in 2023.

The liquidity of the banking sector is sufficient, taking into account the short-term liquidity ratio published in the Financial Soundness Indicators since 2021, in which the liquid assets to short-term liabilities ratio is at 86.4 percent in Q3 2022 increasing from 80.7 percent in Q4 2021. Moreover, the cash reserve ratio of the banking system at about 4.3 percent, of which 3.8 percent is for foreign currency, is well above the regulated level (2 percent) in Q3 2022 and similar to 2019 prior to the COVID-19 pandemic, showing that the cash balance of the banking sector is sufficiently liquid for their day-to-day operations. Although there are some short-term issues with foreign exchange liquidity, it is manageable and the current foreign exchange liquidity pressures would be eased by recent measures. Two state-owned commercial banks have been restructured to improve their performance. The authorities remain vigilant to risks and vulnerabilities to ensure the stability of financial system.

On the capital adequacy ratio of Banque Pour Le Commerce Exterieur Lao Public (BCEL), the slump of its CAR in Q3 2022 is primarily due to flaws in data migration from the implementation of International Accounting Standards. This was corrected in Q4 2022. Additionally, BOL has imposed a prompt corrective action on the bank to submit a remedial plan to BOL, which is currently submitted.

In addition, BOL is in the process of finalizing a number of major prudential regulations to be issued this year, including the amendment of the Law on Commercial Banks, the Decision on Capital Adequacy Requirements, Decision on Net Open Positions, Decision on Liquidity Risk Management, and Notice on Phasing out of Loan Forbearance. The draft amendment of the Law on Commercial Banks requires banks to inject additional capital, restrict foreign exchange operations, and strengthen the dissolution and bankruptcy processes. BOL has issued a notice to commercial banks to submit comments on the draft Capital Adequacy Requirements, which will be in line with Basel III as well as the Decision on Liquidity Risk Management that includes the introduction of Liquidity Coverage Ratio.

Structural reforms

The authorities agree that structural reforms are key to support the economic growth agenda and promote resilience and inclusive growth. They recognize the importance of leveraging the private sector as an engine for growth through reducing the regulatory burden on small businesses; enhancing the consistent and transparent implementation of tax and regulation across all businesses; increasing registration and labour formality; and improving educational attainment and skills training. The government is implementing policy measures under the 9th NSEDP to address these issues, including enhancing trade facilitation to reduce regulatory burden and trade costs; creating a competitive environment for micro, small, and medium-sized enterprises (MSMEs); and developing human resources and workforce skills to improve labour productivity.

The authorities are in the early stage of amending the Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT) law (expected to be completed by 2024) to further reduce risks of criminal economic activity and promote integrity and stability of financial markets. Efforts are underway to enhance implementation capacity and AML/CFT risk awareness of relevant authorities. Commercial banks have put in place rules and mechanisms to support AML monitoring, and to strengthen their staff's capacity and knowledge in this area The National Committee for AML/CFT supported by the AML Intelligence Office have disseminated AML/CFT information to key stakeholders through various channels, including in-person trainings and publications.

Conclusion

The Lao authorities are mindful of the significant challenges that lie ahead to achieve targeted growth and progress toward sustainable development. To address the country's economic challenges, the authorities are determined to put in place and strengthen the necessary steps and in particular are strongly committed to put public debt on a downward trajectory. These efforts should enhance fiscal sustainability and reduce inflation, while promoting private sector development and raising labor productivity to boost economic growth.

The authorities emphasized the importance to address structural weaknesses and create solid foundations to support development goals going forward. In the near term, policies will support growth through ongoing fiscal and monetary consolidation, sound exchange rate management to combat inflation, efficient market functioning and financial stability.

In this context, the authorities would like to express their heartfelt gratitude to the Fund for the consistent support through various technical assistance projects and insightful policy discussions over the years. All recommendations will be taken into consideration and implemented at the appropriate pace to achieve the intended policy outcomes. The authorities look forward to continued engagement as they move forward in their reform agenda.